Articles

SECRETS AND LIENS: THE END OF NOTICE IN COMMERCIAL FINANCE LAW

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ABSTRACT

This Article examines the trend in commercial finance law to reduce or eliminate the obligation to give notice of nonpossessory interests in personal property in systems such as those created by Article 9 of the Uniform Commercial Code. Although the purpose and merits of such systems have long been debated, they have generally been viewed as effective solutions to the problem of secret liens—interests in property that were neither recorded nor otherwise readily observable.

Two recent sets of legislative developments suggest that we may care much less about the problem of secret liens than we are willing to acknowledge. First, recent revisions to Article 9 of the UCC, which governs many commercial finance transactions, tolerate secret liens that may arise on such increasingly important assets such as data, intellectual property, bank accounts, and securities. Second, states have recently begun to enact non-uniform legislation designed to promote asset securitizations. This legislation often gives fully preemptive effect to the parties' contracts, which would, incidentally, appear to displace rules on notice filing that might otherwise apply. It effectively ends the obligation to give notice.

This Article offers three arguments against this trend. First, tolerance of secret liens challenges recent developments in our understanding of the relationship between property rights and information costs. Second, notice filing systems will act as proxy for the information that might otherwise be generated within tightly knit merchant communities. Third, these systems may have important behavioral consequences both for those required to provide the notice and for the audience for the information thus provided. This Article therefore counsels caution in enacting legislation that would diminish or dilute notice filing in commercial finance transactions.

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> *One of the Ten Commandments of Mercantile Law is that an effective [notice] filing system is the center pole that holds up the entire personal property security tent.*[1]
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> *[I]t is certainly observable that [notice] filing offices tend to collect a good deal of dust between the visits of creditors seeking information*.[2]
>
> *Commentators have wondered for some time just what it is we want the [notice] filing system to achieve*.[3]

INTRODUCTION

Pity the poor financing statement.

This much-maligned document was once the centerpiece of most important commercial finance transactions. Until recently, to make generally enforceable any loan or similar transaction involving personal property, this simple statement identifying the borrower, the lender, and the property involved had to be filed in a public office designated by applicable law, usually Article 9 of the Uniform Commercial Code ("UCC").[4] If the form[5] was properly completed and filed, and the underlying contracts were executed, the lender's rights in the borrower's property would be "perfected"—enforceable not only against the borrower but also against anyone else seeking to stake a claim in that property, such as buyers, other creditors, or a bankruptcy trustee.

As a general matter, the function of the financing statement, also known as a "UCC-1," has not been in dispute.[6] In theory, the UCC-1 "put[s] a person *on notice* of the existence of a security interest in a

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[1] James J. White, *Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules*, 79 MINN. L. REV. 529, 530 (1995).

[2] John deJ. Pemberton, Jr., *Notice Filing for Assignment of Accounts Receivable*, 13 LAW & CONTEMP. PROB. 643, 664 (1948) (citation omitted).

[3] Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679, 705 (1995).

[4] U.C.C. § 9-401 (2000); U.C.C. § 9-310(a) (2003).

[5] A form of financing statement as envisioned by UCC § 9-521 is attached as Annex A Copyright by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. Reproduced with the permission of the Permanent Editorial Board for the Uniform Commercial Code. All rights reserved.

[6] As discussed *infra* in Part III, the larger informational system, of which the financing statement is a part, has been the subject of some controversy. Indeed, an entire symposium issue of the *Minnesota Law Review* was devoted to the question. *See "Managing the Paper Trail": Evaluating and Reforming the Article 9 Filing System*, 79 MINN. L. REV. 519 (1995).

particular type of property so that further inquiry can be made . . . ."[7] The role of notice has, in general, also been well understood: "[O]ne of the most firmly rooted doctrines of the common law," Grant Gilmore has observed, was "the protection of creditors against undisclosed interests in property."[8]

The financing statement has thus been viewed as a potent antidote to the problem of secret liens—the ancient conflict that arises whenever one party asserts an interest in property that is neither recorded nor otherwise readily observable.[9] Secret liens are universally castigated. As the United

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[7] Heights v. Citizens Nat'l Bank, 342 A.2d 738, 743 (Pa. 1975). "The purpose of a notice filing statute is to give protection to a creditor by furnishing to others intending to enter a transaction with the debtor a starting point for investigation which will result in fair warning concerning the transaction contemplated." TMMB Funding Corp. v. Associated Food Stores, Inc., 136 A.D.2d 540, 542 (N.Y. App. Div. 1988) (citation omitted); *see also* Marine Drilling Co. v. Hobbs Trailers, 697 S.W.2d 831 (Tex. Ct. App. 1985); Waterfield v. Burnett (*In re* Burnett), 21 B.R. 752 (Bankr. D.N.M. 1982); Abney v. I.T.T. Diversified Credit Corp. (*In re* Envtl. Elec. Sys., Inc.), 11 B.R. 965 (Bankr. N.D. Ga. 1981).

[8] 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 3.2, at 67; § 8.7, at 274 (1965) ("In the history of our security law there has been one constant factor: whenever a common law device has been covered by a statute, some form of public recordation or filing has been required as a condition of perfection of the security interest."). Gilmore was a principal drafter of the UCC As Peter Coogan, another prominent participant in the development of the UCC, explained:

> A history of chattel security could well be written in terms of the 400 year struggle by debtors and their secured creditors to create security interests of various sorts in the debtors' property without affording notice to buyers or other creditors, and the attendant demands by unsecured creditors generally for some kind of notice when all or part of the debtors' assets become subject to security interests. The parties favoring secrecy have, for the most part, been the losers.

Peter F. Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289 (1962) (footnote omitted).

[9] *See, e.g.*, Nunnemaker Transp. Co. v. United Calif. Bank, 456 F.2d 28, 36 (9th Cir. 1972) (suggesting in dicta that there is "no risk of a secret lien" where there has been "compliance with the notice filing provisions of the Uniform Commercial Code") (citations omitted); Admor's Office World, Inc. v. Bank Leumi Trust Co. (*In re* Admor's Office World, Inc.), No. 91-B-10773, 1992 WL 350577, at *2 (Bankr. S.D.N.Y. Nov. 12, 1992) ("The Code seeks to protect against the secret lien and at the same time to promote notice filing.") (citing Matter of Pasco Sales Co., 52 A.D.2d 138, 143 (N.Y. App. Div. 1974); Beneficial Fin. Co. v. Kurland Cadillac-Oldsmobile, Inc., 32 A.D.2d 643, 645 (N.Y. App. Div. 1969)); United States v. Birco Mining Co. (*In re* Birco Mining, Inc.), 10 B.R. 545, 548 (Bankr. N.D. Ala. 1981) ("The law decries a 'secret lien,' *Corn Exchange Bank v. Klauder*, 318 U.S. 434 [(1943)], and notice filing is now an accepted part of commercial law.").

As Professor Alces explained:

> The filing system [] prevents pure debt or fraud—the kind that the debtor commits without the help of a collusive creditor by granting successive collateral interests in the same property without notifying each secured party of the (prior) adverse claimants. This is the true secret lien problem and, for some, it is the *raison d'etre* of the filing system. If the filing system did not provide an effective means to avoid the risk of pure debtor fraud, there might not be any remaining viable argument in favor of the filing system. So if there is to be a filing system, it must reduce, if not eliminate entirely, this fraud risk.

States Court of Appeals for the Fourth Circuit observed long ago, "[s]ecret liens have always been repugnant to the law."[10] Karl Lewellyn more colorfully equated the secret lien with "that rat in Denmark."[11]

The problem of secret liens is, in many respects, central to basic questions posed by property law: Who has what rights with respect to what things? At this level, property law addresses what Thomas Merrill and Henry Smith characterize as a "massive coordination problem."[12] When property law works, it does so because, as Carol Rose has observed, its "rules . . . signal to all of us, in a clear and distinct language, precisely what our obligations are and how we may take care of our interests . . . . I know where I stand and so does everyone else" in relation to any given item of property.[13] The problem of secret liens challenges all of this because the secrecy of the property interest obscures—indeed, cloaks—the signal that would otherwise tell the world that someone has a nonpossessory interest in the encumbered property.

Despite many legitimate concerns with secret liens, two recent sets of legislative developments suggest we may care much less about the problem than we are willing to acknowledge. First, Article 9 of the UCC,

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Alces, *supra* note 3, at 703.

[10] Holt v. Albert Pick & Co., 25 F.2d 378, 380 (4th Cir. 1928); *see In re* Reliance Equities, Inc., 966 F.2d 1338, 1343 (10th Cir. 1992) ("'[T]he Bankruptcy Act abhor[s] secret liens. . . .") (citation omitted); *In re* Brownsville Brewing Co., 117 F.2d 463, 464 (3d Cir. 1941) (characterizing Pennsylvania as "a State whose 'abhorrence of the secret lien' did not even admit of the palliative of recording") (quoting Martin v. Mathiot, 14 Serg. & Rawle 214 (Pa. 1826); Commercial Casualty Ins. Co. v. Williams, 37 F.2d 326, 327 (4th Cir. 1930) ("Secret liens are repugnant to the law . . . ."); H.K. Porter Co. v. Boyd, 171 F. 305, 312 (3rd Cir. 1909) ("No citation of authority is requisite to support the proposition that . . . a secret lien could not avail against an attachment or execution creditor, not chargeable with knowledge or notice of its existence . . . ."); *In re* Nolan Motor Co., 25 F. Supp. 186, 189 (D.D.C. 1938) ("The giving of a secret lien and the attempt to enforce such a lien against the claims of creditors represented by the trustee in bankruptcy is repugnant not only to the spirit but to the letter of the Bankruptcy Act."); *In re* Collins Hosiery Mills, 19 F. Supp. 500, 502 (E.D. Pa. 1937) ("[T]he common law of Pennsylvania . . . abhors a secret lien."); *In re* Stein, 17 F. Supp. 587, 591 (E.D. Pa. 1936) (Dickenson, J., dissenting) ("[T]he law abhors secret liens and the like."); *In re* J.F. Grandy & Son, 146 F. 318, 323 (D.S.C. 1906) (A "secret lien would be abhorrent to equity . . . ."); *In re* Noack, 44 B.R. 172, 175 (Bankr. E.D. Wis. 1984) ("In the final analysis, the facts of each *particular* case shall govern, always bearing in mind the Uniform Commercial Code's abhorrence of secret liens.") (citing JAMES J. WHITE & ROBERT S. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 22-3, at 883 (2d ed. 1980)); *In re* Loop Hosp. P'ship, 35 B.R. 929, 936 (Bankr. N.D. Ill. 1983) ("The UCC has an 'abhorrence of secret liens.'") (citing WHITE & SUMMERS, HANDBOOK OF THE LAW UNDER THE UCC § 22-3, at 883 (2d ed. 1980)). For a general discussion of secret liens, see Julian B. McDonnell, *in* 1 PETER F. COOGAN ET AL., SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶¶ 1.01-1.06 (1999).

[11] *See* Karl N. Llewellyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725, 730 (1939).

[12] Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 387 (2001) [hereinafter Merrill & Smith, *Law and Economics*].

[13] Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988).

which governs many commercial finance transactions, and which was revised effective 2001,[14] appears increasingly tolerant of secret liens. For a variety of complex reasons explained below (some intended, some perhaps not), security interests in such important assets as data, intellectual property, bank accounts, and investment securities will in many cases be undiscoverable from the public record.

Second, and perhaps more controversially, several states have recently enacted non-uniform legislation designed to promote asset securitizations.[15] At least in theory, a securitization differs from a traditional loan because the "debtor" in the securitization "sells" property, rather than encumbers it. Sometimes called "structured financings," transactions with these general contours were apparently central to much of Enron's activities.[16]

The drive to enact facilitation statutes stems in large part from a concern that courts may second-guess the contracted-for character of the transaction, and treat it not as a sale, but as a financing.[17] If so, the property allegedly sold would remain available for the debtor's other creditors to share if the debtor went into bankruptcy. These statutes purport to solve this problem by giving full preemptive power to the underlying contracts (e.g., the sales documents).[18] If these statutes mean

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[14] Revised Article 9 has been enacted in all states and in most went into effect July 1, 2001. *See* National Conference of Commissioners on Uniform State Laws, *Why States Should Adopt the Uniform Commercial Code—Revised Article 9*, *at* http://www.nccusl.org/Update/uniformact_why/uniformacts-why-ucca92.asp (last visited Feb. 22, 2005).

[15] *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2004). Other states that have recently enacted similar statutes include Alabama, ALA. CODE § 35-10A-2(a)(1) (2004); Louisiana, LA. REV. STAT. ANN. § 10:9-109(e) (West 2002); North Carolina, N.C. GEN. STAT. § 25-9A-102 (2002); Ohio, OHIO REV. CODE ANN. § 1109.75 (Anderson 2002); Texas, TX. BUS. & COM. § 9.109(e) (Vernon 2002). The most recent addition to the field is Virginia, VA. CODE ANN. § 6.1.473 (Michie 2004).

[16] There has already been some effort to distinguish securitizations from the types of transactions in issue in Enron. *See, e.g.*, Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309, 1314 (2002) [hereinafter Schwarcz, *Enron*]. Schwarcz has argued that "unlike in *Enron*, structured transactions [(securitizations)] typically transfer substantive risk away from the company originating, or sponsoring the transaction . . . ." Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 3-4 [hereinafter Schwarcz, *Complexity*]. As discussed in Part II.C., *infra*, the securitization facilitation statutes would, by their terms, insulate these transactions from all other applicable rules, including those on notice filing, even if they had none of the distinctive virtues identified by Professor Schwarcz. *See* Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRAC. 101 (2002) [hereinafter Lipson, *Enron*] (discussing Enron's use of securitization).

[17] Securitization has, in Professor Mann's view, "produced a powerful impetus for legislation ensuring that those transactions receive favorable treatment in bankruptcy." Ronald J. Mann, *The Rise of State Bankruptcy-Directed Legislation*, 25 CARDOZO L. REV. 1805, 1816 (2004).

[18] *See supra* note 15.

what they say, they should create an enormous exception to all state-law based notice filing systems, including those contemplated by the UCC. They effectively end the obligation to give notice.

This Article considers how we have come to diminish the role of notice filing and what that might mean. Although the subject matter may be technical, the thesis of the Article is simple: Reducing public notice of nonpossessory interests in property increases the likelihood of secret liens, which, in turn, creates direct and indirect costs (economic and otherwise) that have not been fully considered.

Part I provides a brief history of notice in commercial finance law and the role that notice filing has played in generating and disseminating information about property in and across commercial communities. This information has historically played an important part in deterring—or avoiding—secret liens. Part I concludes with a discussion of the modern systems by which notice of nonpossessory interests is given in commercial finance transactions, including the UCC-1 financing statement system.

Part II explains in detail three common sets of commercial finance transactions that may now, despite these systems, give rise to secret liens: (i) secured transactions involving data or intellectual property; (ii) control security interests; and (iii) asset securitization transactions subject to facilitation statutes. In all three, a secured party, or other financing party, will have a nonpossessory interest in a debtor's property that is not readily discoverable from the public record. Even if such transactions were not intended to harm creditors or anyone else, they would nevertheless create secret liens because there is no public, verifiable system that determines the existence and nature of these rights.

Part III considers how our law has grown—and continues to grow—increasingly tolerant of secret liens. This Part argues, in essence, that we have been seduced by a series of arguments about the economics of commercial finance law and notice filing. Economically, the arguments posit, notice filing regimes impose direct and indirect costs of compliance that fail to produce corresponding informational benefits. Unfortunately, the economic arguments are incomplete, often speculative, and, in any case, lack empirical support.

Part IV considers these developments in light of three arguments against this trend and in favor of more widespread notice filing regimes. First, this Part examines the trend in property theory to link property rights with information costs. The recent work of Thomas Merrill and Henry Smith, for example, suggests that property rights arise and are enforceable when they are readily discoverable.[19] Undercutting the notice filing system challenges this developing understanding of property rights.

Second, this Part examines the role that information about property plays more generally in commercial communities, based both on the historical analysis set forth in Part I and the recent empirical work of Robert Ellickson[20] and Lisa Bernstein,[21] whose findings suggest that community structures can often be a proxy for more formal information-generating rules which might govern notice filing. An inference from their work, however, might be that in the absence of well-defined community structures, more formal information devices like notice filing take on increasing importance.

Third, this Part considers some of the behavioral implications of notice filing and, in particular, the indirect effects that mandatory notice filing might have on those obligated to make the filings. This Part observes that forcing debtors to disclose information in financing statements may have valuable cautioning and reflexive functions, which provide systemic integrity.

The Article concludes not with a call for reform, but instead a note of caution, urging those who would further undermine the UCC-1 financing statement system to consider carefully the collateral consequences of such moves.

I. A SHORT HISTORY OF NOTICE, PROPERTY, AND COMMUNITY IN

19 *See, e.g.*, Merrill & Smith, *Law and Economics*, *supra* note 12; Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000) [hereinafter Merrill & Smith, *Optimal Property*]; Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 833-42 (2001) [hereinafter Merrill & Smith, *Interface*]. Henry Smith has elaborated on some of their work in Henry E. Smith, *The Language of Property: Form, Context and Audience*, 55 STAN. L. REV. 1105 (2003). A recent article critical of certain aspects of the Merrill and Smith approach appears in Henry Hansmann and Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373 (2002). As discussed *infra*, Hansmann and Kraakman nevertheless claim there exists a strong link between notice and property rights, a claim which current trends would appear to undermine. *See infra* notes 366-70 and accompanying text.

20 ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 52-53, 72-76 (1991) [hereinafter ELLICKSON, ORDER]; Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1320-21 (1993).

21 *See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Imminent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Diamond Industry*]; Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001).

COMMERCIAL FINANCE LAW

The problem of secret liens is, in many respects, a subset of the basic informational problems embodied in the law of property: How do we know who has what rights with respect to what things? Historically, information about property was signaled by physical phenomena: Peaceful possession, for example, was often strong evidence of ownership. This may have made sense in a simpler world. As societies became more complex and disaggregated, however, physical observations in defined community structures could no longer provide reliable information about a debtor's property. As increasingly complex (and potentially devious) transactions occurred in increasingly sophisticated forms, notice filing became a proxy for the information and controls that community might otherwise have provided.

A. Possession as Notice

Historically, possession was viewed as the basis of property rights,[22] and this would appear to be as true of the security interest ("pledge") as any other property interest.[23] If creditor *A* took possession of debtor *B*'s flock of sheep to secure *B*'s debt to *A*, at least in theory, there would be no doubt in the minds of those asserting an interest in *B*'s property about *B*'s rights in the sheep: To all appearances, he had none. And, conversely, where *B* did have possession, it would be reasonable for creditors or purchasers to conclude that he did, in fact, have title or some other equally important set of rights (e.g., a lien). Possession was property. Or,

[22] *See, e.g.*, Richard Epstein, *Possession as the Root of Title*, 13 GA. L. REV. 1221 (1979); Carol M. Rose, *Possession as the Origin of Property*, 52 U. CHI. L. REV. 73 (1985) [hereinafter Rose, *Possession*]. Or, in the immortal words of English playwright Colley Cibber (1671-1757), "Possession is eleven points in the law." COLLEY CIBBER, WOMAN'S WIT, act 1.

[23] "The legal system's original method of providing [information about ownership] was to give primacy to possession. At common law, a debtor's possession of personal property assured a prospective creditor that the debtor could give him an unencumbered interest in that property." Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 180 (1983) (footnote omitted) [hereinafter Baird & Jackson, *Possession and Ownership*]. According to Baird and Jackson, this was because "possession has been viewed as the best available source of information concerning 'ownership' of most types of personal property." *Id*. (citing 13 Eliz., c. 5 (1570); *Twyne's Case*, 76 Eng. Rep. 809 (1601)). Baird and Jackson have developed a fairly elaborate theory about the relationship between property rights and information, which has important implications for the ongoing debate about the notice filing system. *See* Douglas G. Baird & Thomas H. Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 292 [hereinafter Baird & Jackson, *Uncertainty*]; *see also* Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53 (1983) [hereinafter Baird, *Ostensible Ownership*].

perhaps more accurately, the signal sent by peaceful possession was said to justify the conclusion that the possessor had a "property interest" in the thing possessed.

Perhaps the most famous articulation of the link between notice and possessory property rights in the commercial context appears in *Clow v. Woods*.[24] In *Clow*, a tanner, Hancock, conveyed to creditors, Clow and Sharp, mortgages on Hancock's vats of hides and tanning equipment.[25] The creditors neither took possession of this personal property collateral nor recorded the mortgage.[26] The debtor's former business partner, Poe, sued for his share of the value of the firm, obtained a judgment, and sent the sheriff to execute on the same hides and equipment.[27] The secured creditors sued the sheriff seeking to recover the proceeds of the sale of this property, arguing in substance that their mortgage had priority over Poe's execution lien.[28] Unfortunately for the secured creditors, the Pennsylvania Supreme Court declined to enforce their mortgage, viewing it as fraudulent in law, if not in fact.[29]

Clow turned, in significant part, on the informational problem created by the separation of property right from possessory fact. Judge Gibson reasoned that the "secrecy" of the mortgages (security interests) would harm other creditors of the debtor, Hancock, because these other creditors would mistakenly rely on the apparent value of his hides and equipment in deciding to lend to him.[30] His ownership of this property, ostensibly free and clear of the rights of all others, would induce unwitting, and perhaps unsophisticated, creditors to extend unsecured credit at their peril. Judge Gibson opined:

> [A] creditor ought not to be suffered to secure himself by means that may ultimately work an injury to third persons . . . . Where possession has been retained without any stipulation in the conveyance, the cases have uniformly declared that to be, not only evidence of fraud, but fraud per se. Such a case is not inconsistent with the most perfect honesty; yet a court

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[24] 5 Serg. & Rawle 275 (Pa. 1819).

[25] *Id*. at 276.

[26] *Id*.

[27] *Id*.

[28] *Id*.

[29] *Id*. at 283, 288. The court held the mortgage transaction was a per se fraud against creditors and was void under the Statute of 13 Elizabeth. *Id.* at 288. As discussed *infra*, the Statute of 13 Elizabeth was the earliest form of the prohibition on transfers of property that hinder, delay, or defraud creditors. *See infra* notes 53, 55-61 and accompanying text.

[30] *Clow*, 5 Serg. & Rawle at 279 (The contract between the debtor and creditors was a "secret matter[] between the parties themselves, and can afford no notice to creditors.").

> will not stop to inquire, whether there be actual fraud or not; the law will impute it, at all events, because it would be dangerous to the public to countenance such a transaction under any circumstances. The parties will not be suffered to unravel it, and show, that what seemed fraudulent, was not in fact so. Would it be less against sound policy to suffer a vendor to remain in possession, under an agreement to that effect expressed in the conveyance, and thus to create a secret [e]ncumbrance on his personal property, when to the world he appears to be the absolute owner, and gains credit as such.[31]

Clow thus articulated what came to be known as the problem of ostensible ownership—the making of credit or other investment decisions in reliance on the potentially misleading appearance that a debtor has rights in property by virtue of physical possession.[32]

Some have questioned whether ostensible ownership creates much of a problem.[33] Professor Mooney, for example, has argued that creditors and others are unlikely to rely, reasonably or otherwise, on the mere fact that a debtor possessed certain assets when making a credit or other investment decision.[34] Mooney's argument centers principally on proposals to extend notice filing rules to personal property leasing transactions.[35] Mooney successfully argues notice filing would add nothing to such transactions because sophisticated creditors either already knew the debtor leased its property, or did not care one way or the other.[36] Because ostensible ownership problems by definition involve misplaced reliance on a debtor's property, and creditors rarely rely in "unreasonable" ways, Mooney concludes that "[p]erhaps there is no real 'problem' at all."[37]

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31 *Id*. at 280, 281.

32 *See* Baird & Jackson, *Possession and Ownership*, *supra* note 23, at 178 n.15.

33 *See, e.g.*, Charles Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 725-38, 738 n.160 (1988) [hereinafter Mooney, *Myth*] (critiquing claim that possession creates an "ostensible ownership" problem).

34 *Id*. at 740 ("Although hard empirical data remains elusive, a review of Code cases dealing with priority disputes between lessors and third parties supports the argument that mistaken and detrimental reliance on lessees' possession of equipment is not commonplace.") (footnote omitted).

35 *See generally* Amelia H. Boss, *The History of Article 2A: A Lesson for Practitioner and Scholar Alike*, 39 ALA. L. REV. 575 (1988).

36 Mooney, *Myth*, *supra* note 33, at 785-88.

37 *Id*. at 740. It should be noted that personal property leasing cases sometimes have important implications for notice filing. The so-called recharacterization cases hold generally that a lease that was, in substance, a secured financing may be recharacterized as such and, if the lessor (read: secured party) failed to give required notice, it would lose its priority to a bankruptcy trustee. *See, e.g.*, Duke

While possession technically remains a viable method of creating and enforcing property interests in commercial finance transactions,[38] it would appear Mooney is at least partially right because it is simply not clear what "possession" means.[39] As any first-year law student can attest, possession is a highly elusive concept. In simpler times, Professor Rose may well have been correct that original possessory claims to property "look[] like a kind of speech, with the audience composed of all others who might be interested in claiming the object in question."[40] Today, however, we do not "possess" most of the things we claim to possess in ordinary language. Professor Schroeder has elaborated on this point, noting that the enormous number of potential, complex property relationships, coupled with the development of fictitious legal entities such as corporations, which may hold and convey interests in property, make physical custody an extremely poor signal of any information about either the property itself or its "ostensible" owner.[41]

Energy Royal, LLC v. Pillowtex Corp. (*In re* Pillowtex, Inc.), 349 F.3d 711 (3d Cir. 2003) (setting forth criteria for determining whether transaction is a "true lease" or "disguised financing"); *In re* PCH Assocs., 949 F.2d 585, 595-97 (2d Cir. 2001) (citing PCH Assocs. v. Liona Corp., 55 B.R. 273 (Bankr. S.D.N.Y. 1985)); *In re* Independence Vill., Inc., 52 B.R. 715 (Bankr. E.D. Mich. 1985).

UCC § 9-505 now explicitly contemplates—and permits—the filing of precautionary financing statements. In at least some states that might be a good idea, because a sale-leaseback that is not recorded may be treated as a fraudulent transfer. California Civil Code § 3440, for example, makes a sale-leaseback void as against creditors of the transferor unless a UCC financing statement is filed in the office of the California Secretary of State prior to the sale and a notice of the intended transfer is published not less than ten days before the transfer. CAL. CIV. CODE § 3440 (West 2004).

[38] UCC § 9-313(c) provides that a secured party may take and perfect a possessory security interest in certain types of collateral in the physical possession of some third party (i.e., not the debtor) so long as the third party has agreed that it holds the collateral for the benefit of the secured party. Possessory security interests are not only permitted with respect to most tangible collateral, but are actually required to perfect a security interest in money. *Id*. § 9-312(b)(3). The possessory security interest is presumed to perform the informational functions one might ordinarily associate with notice filing because it is an exception to the general rule that a financing statement must be filed to perfect a security interest. *Id.* § 9-310(b)(6). It is also considered a proxy for the contract that creates a security interest, a written or electronic security agreement. *Id.* § 9-203(b)(3)(B)-(C). This is somewhat surprising, given that the UCC provides no guidance about what "possession" might mean for these purposes. The UCC "does not define 'possession.'" *Id.* § 9-313 cmt. 3. The UCC "adopts the general concept [of possession] as it developed under former Article 9." *Id.* While former Article 9, § 9-305, certainly contemplated the creation and perfection of security interests by secured party possession, it also said little about what possession might have meant in this context. *See* U.C.C. § 9-305 (2000).

[39] It is this uncertainty that led Professor Phillips to observe that "business people look to written, not possessory evidence of ownership. And this view leads generally to recognizing filing, but not possession[,] as a means of notice." David M. Phillips, *Flawed Perfection: From Possession to Filing Under Article 9* (pt. I), 59 B.U. L. REV. 1, 35 (1979).

[40] Rose, *Possession*, *supra* note 22, at 78-79.

[41] *See* Jeanne L. Schroeder, *Death and Transfiguration: The Myth that the U.C.C. Killed*

The ambiguity of possession also infects the creditor's side of things. For example, even if a lender has actual physical possession, we still do not know what to make of potential creditors of the possessory creditor. After all, it is entirely conceivable that *A* (*B*'s creditor) may take possession of *B*'s property to secure *B*'s obligation. But it is at least theoretically possible that *A* may have its own creditor or purchaser (*C*).[42] Why should *C* be any less gullible than *B*'s creditors? Does not *A*'s possession of *B*'s property signal to *A*'s secondary stakeholders, such as *C*, the very same thing that *B*'s possession would signal to *B*'s creditors, etc?[43] How would *C* know from observing *A*'s possession that *B* retains an interest (e.g., equity) in the property?

Possession undoubtedly sends an ambiguous signal, but that is only half the story. As discussed in Part IV.C *infra*, we are just beginning to develop theories about how human beings process information and form judgments in the presence of ambiguity. It would appear that in smaller and more tightly knit communities, possession may well have been an effective signal. Otherwise, it seems unlikely possession could ever have been an acceptable means of distributing property rights. If so, *Clow* is ultimately wrong in result, even if it may be correct in its policy concerns. If, as seems likely, Hancock's creditors—and in particular, Poe, the creditor and former business partner—knew or had reason to know that Clow and Sharp had a mortgage on Hancock's property, what value would notice filing or creditor possession have added? How did Poe or anyone else mistakenly rely on Hancock's (the debtor's) possession?

"Property," 69 TEMP. L. REV. 1281 (1996); Jeanne L. Schroeder, *Some Realism About Legal Surrealism*, 37 WM. & MARY L. REV. 455, 486-87 (1996) [hereinafter Schroeder, *Surrealism*] ("Regardless of what has been historically assumed, contemporary property practices suggest that, today, physical custody provides very, very little (if any) information about ownership."). Professor Schroeder thus argues with some force that possession in commercial law is at best a metaphor for what she calls "sensuous grasping." *Id.* at 455. Yet, as Schroeder observes, it is a metaphor that fails to serve commercial law well. *Id.* at 492. It is simply not meaningful to view transactions in intangible property—which is increasingly where the real value is—as like a physical conveyance, a simple "farmer's transaction." *Id.* (citing Karl N. Llewellyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725, 732 (1939)). For example, investment property (e.g., stocks and bonds) often exists in complex networks of computers which are owned, and perhaps "possessed," by firms, which are then linked in complex, pyramidal broker-dealer relationships. *See Prefatory Note*, U.C.C. Art. 8 (1994) (discussing evolution of securities holding systems).

42 *See* Baird & Jackson, *Uncertainty*, *supra* note 23, at 307.

43 Baird and Jackson dismiss this problem of "repledge" as being "largely a theoretical one." *Id*. Presumably they were not thinking about the role that transactions of this type play in the securities markets. Professor Kettering has, however, found examples of this problem, especially as to the complex pyramidal transactions among securities broker-dealers. *See* Kenneth C. Kettering, *Repledge and Pre-Default Sale of Securities Collateral Under Revised Article 9*, 74 CHI-KENT L. REV. 1109 (1999).

Perhaps the ultimate problem with the possessory security interest has only indirectly involved information. This is the practical problem arising from the fact that, as the economy grew in depth, breadth, and complexity, possessory security interests became neither useful nor appealing to those engaged in increasingly sophisticated mercantile transactions.[44] If true to form, the debtor could not possess or make use of property held by the secured creditor. Hancock, the tanner in *Clow*, would not have been able to produce the leather goods that were presumably his stock in trade and the sale of which would make it possible for him to repay the loan. If not true to form, there remained the distinct possibility of ex post judicial nullification. For manufacturers, this meant their equipment could not secure a loan; for merchants, the same prohibition limited the value of their inventory. Nor could future interests secure present loans. Nor could intangible rights serve as collateral, and so on. Possession thus became a speed bump on the road to increasingly complex, disaggregated property rights.[45] Increasingly dynamic uses of property would render possession vestigial at best and misleading at worst.

B. Notice Systems

Given these problems with the possessory security interest, it is not surprising that pressure developed to find an alternative to the information problems presented by the possessory security interest. The alternative was notice filing.[46] Linking the right to enforce a nonpossessory interest in property (e.g., a security interest) to publicly filed notice of that interest has had a long and complex career. Since notice filing systems exploded with the disaggregation of community during the industrial revolution, it may also be that notice filing developed as a proxy for the information that possession would once have provided to creditors in smaller, more tightly-knit communities.

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[44] Baird & Jackson, *Uncertainty*, *supra* note 23, at 308.

[45] *See* JAMES WILLARD HURST, LAW AND THE CONDITIONS OF FREEDOM 9-10 (1956) ("[P]revailing nineteenth century attitudes in fact made private property pre-eminently a dynamic, not a static institution.").

[46] At least originally, however, it was not considered to be a particularly good one. Professor Gilmore observed, "[o]riginally filing was looked on as merely an alternative, a less desirable alternative, to possession taken by the secured party." GILMORE, *supra* note 8, § 15.1, at 462.

1. *The Roots of Notice Filing: Recordation, Fraudulent Conveyance, and Sign Posting*

Separating property from information about it—conveying property information in some way other than possession—well precedes the modern notice filing systems we have today.[47] Indeed, even while *Clow* might have counseled that possession was the only (or principal) method of creating an effective security interest in personal property in the early nineteenth century, real property rights were already being reified in recordation systems that would be the forerunners of the notice filing systems that became ubiquitous in the latter half of that century.

In England, for example, recordation systems developed with respect to real property and were used as a matter of choice[48] or custom.[49] In

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[47] At one level, linking nonpossessory property rights to notice goes back at least as far the ancient Greeks, for whom the "horos" gave posted notice of an interest in real property. As Benito Arruñada explains:

> [*H*]*oroi* contained the essential data of the encumbrance (always, the nature of the *horos* as security, and more often, but not always, the existence of a written agreement, the name of the creditor, and the amount of the debt) and, in some cases, the name of the person who kept the document of the transaction, supposedly to make it possible for third parties to collect more information. This system was one of the first to make an *hypotheca* possible—namely the use of land as collateral without temporarily transferring ownership or possession to the lender.

Benito Arruñada, *Property Enforcement as Organized Consent*, 19 J.L. ECON. & ORG. 401, 412 (2003).

[48] *See* John Hanna, *The Extension of Public Recordation*, 31 COLUM. L. REV. 617, 620 (1931) ("Prior to the Norman [C]onquest there seems to have been a system of voluntary registration of land deeds in monasteries."). Even where not voluntary, Professor Bowers reports they may have been easily circumvented. *See* James W. Bowers, *Of Bureaucrats' Brothers-in-Law and Bankruptcy Taxes: Article 9 Filing Systems and the Market for Information*, 79 MINN. L. REV. 721, 722-23 (1995). The 1535 English Statute of Enrollments, which required recordation of a "bargain and conveyance" of real property often failed, Bowers argues, because lawyers simply papered around the transaction. *Id.* at 731; *see* Hanna, *supra*, at 619 (discussing Statute of Enrollments).

[49] In a 1907 issue of *Green Bag*, Joseph H. Beale, Jr. suggests borough custom in England required the registration of deeds to real property and might have influenced the settlers in Massachusetts and Virginia. *See* Joseph H. Beale, Jr., *The Origin of the System of Recording Deeds in America*, 19 GREEN BAG 335, 338 (1907). The custom of London, for example, was said to be as follows:

> The persons that sealed the deed must go before the Lord Mayor, or the Recorder and one Alderman, and make acknowledgement that the same is their act and deed; if a wife be a party, she is to be examined by them, whether it was done with her full and free consent, without any kind of compulsion; in testimony of which the Lord Mayor or the Recorder and Alderman set their hands to it, for which each may demand 4*d*[] and the attorney's fee for the judgment is 2*d*. Afterwards the deed must be delivered to the clerk of the Inrolments [sic] who at the next Hustings will cause proclamation to be made thereof according to the customs of the court.

Id. (quoting WILLIAM BOHUN, PRIVILEGIA LONDINI 241 (3d ed. 1723)).

colonial North America, real property recording systems performed several different functions. Certain communities in Massachusetts, for example, may have used recording and acknowledgment rules to limit the admission of new members of the community or to control improvements to property.[50] More frequently, it appears that recordation was viewed as a way to address the problem of fraudulent conveyance—a conveyance intended to place property out of the reach of creditors.[51] For example, in 1640, both Jamestown[52] and the Massachusetts court[53] enacted rules providing that a nonpossessory interest in real property—title or mortgage—would be treated as fraudulent unless publicly recorded.[54]

The problem of fraudulent conveyances appears to have had a significant influence on the development of notice filing rules and provides some insight into the historic role that community might play in all of this. In *Twyne's Case*,[55] for example, one Pierce was indebted to

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[50] *Id*. at 336-37 (citing BOSTON RECORD COMMISSIONER'S REPORTS, vol. iv., p. 8 & vol. ii, p. 5 (1635); CAMBRIDGE TOWN RECORDS, vol. ii. pp. 4, 10 (1632)).

[51] *Id*. at 335 (citing HENING'S STATUTES, vol. I, p. 227); *see* Mark DeWolfe Howe, *The Recording of Deeds in the Colony of Massachusetts Bay*, 28 B.U. L. REV. 1 (1948).

[52] Beale, *supra* note 49, at 335.

[53] *Id*. at 337. The Massachusetts rule provided as follows:

> For avoyding all fraudulent conveyences, & that every man may know what estate or interest other men may have in any houses, lands or other hereditamants they are to deale in, it is therefore ordered, that after the end of this month no morgage, bargaine, sale, or graunt hearafter to bee of any houses, lands, rents, or other hereditamants shalbee of force against any other person except the graunter & his heires, unless the same bee recorded, as is hereafter expressed.

I Records of Massachusetts 116 (1640).

Perhaps foreshadowing the streamlined notice requirements of the UCC, the ordinance further provided that "it is not intended that the whole bargaine, sale, & c. shalbee entered, but onely the names of the graunter & grauntee, the thing & the estate graunted & the date; and all such entryes shalbee certified to the recorder at Boston." Beale, *supra* note 49, at 337. As discussed below, the modern UCC-1 financing statement requires only a cursory recitation of the debtor (grantor), secured party (grantee), and brief description of the collateral. U.C.C § 9-503(a) (2003).

Hanna also suggests colonial law embraced recordation as a response to the problem of fraudulent conveyance. *See* Hanna, *supra* note 48, at 620 ("England has influenced American law makers in the drafting of recording statutes . . . as [demonstrated by] the statutes of fraudulent conveyances and reputed ownership.") (citing Statute of Elizabeth, 13 Eliz., c. 5 § 2 (1570)).

[54] Professor Howe uncovered certain amendments to Massachusetts' statute suggesting that recording was required only where a grantor (i.e., debtor) retained possession following a conveyance. *See* Howe, *supra* note 51, at 4 ("[T]he provision in the Code of 1648 makes it abundantly clear that recording would thereafter be required only if the grantor remained in possession.").

[55] 76 Eng. Rep. 809 (Star Chamber 1601). The Star Chamber was enforcing the Statute of 13 Elizabeth, *id.* at 810, which provided that transfers with the "intent[ ] to delay, hinder or defraud, creditors and others" were void, provided for recovery of the "whole value of . . . goods and chattels" transferred, to be shared by the Crown and aggrieved parties, such as creditors, and provided for

Twyne and to another creditor.[56] "In secret," however, Pierce conveyed all of his property to Twyne in satisfaction of the debt.[57] Despite the conveyance, Pierce nevertheless continued to act as if the property remained his, including by marking and selling sheep as if they were his, and not Twyne's.[58] In avoiding the conveyance, the Star Chamber reasoned "a secret transfer is always a badge of fraud."[59]

One way to understand fraudulent conveyance was as an affront to community norms. The statute that *Twyne's Case* enforced—the Statute 13 Elizabeth chapter 5—was enacted in part to deal with debtors who would remove themselves and/or their property from the community once it became apparent that they could not satisfy their debts.[60] Professor Flint explains:

> Overburdened debtors in the fourteenth and fifteenth centuries frequently transferred all their lands and goods to their friends in trust for use of the grantor through fictitious sales, fled to one of the numerous sanctuaries where the king's courts' power did not govern, lived luxuriously from the income of the property transferred until the creditor accepted payment of a small portion of the debt and released the remainder, then returned, and had back their property.[61]

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criminal sanctions against the parties to the transfer. 13 Eliz., c. 5 § 2.

56 *Id.* at 810-11.

57 *Id.* at 811.

58 *Id.*

59 *Id.* Professor Mooney and others have argued that *Twyne* was a case chiefly about fraud and not, as Baird and Jackson claim, about ostensible ownership. *See* Mooney, *Myth*, *supra* note 33, at 727 n.166. *Cf.* Baird & Jackson, *Ostensible Ownership*, *supra* note 23.

60 *See supra* note 55 for the text of Statute 13 Elizabeth c. 5. The Statute of Elizabeth is the forerunner of all modern fraudulent conveyance statutes, including the Uniform Fraudulent Conveyance Act, 7A U.L.A. 2 (1999) and the Uniform Fraudulent Transfer Act, 7A U.L.A. 266 (1999). Either the Fraudulent Conveyance Act, the Fraudulent Transfer Act, or a common law expression of the Statute 13 Elizabeth is in force in every state in the United States.

61 George Lee Flint, Jr., *Secured Transactions History: The Fraudulent Myth*, 29 N.M. L. REV. 363, 380 (1999) (citations omitted) [hereinafter Flint, *Fraudulent Myth*]. The problem of fraudulent conveyance differs in some respects from the problem of secret liens. At least historically, as in *Twyne's Case*, a fraudulent conveyance involved a transfer of property after a debt was incurred and not satisfied. Placing the property out of reach of the creditor was the chief evil in such cases. Secret lien cases, however, often involved a transfer of property prior to a debt being incurred. The problem of fraudulent conveyance is thus largely ex post, while the problem of secret liens may be ex post or ex ante. Yet the essential informational problem is the same in both. The actual secrecy of the transaction in *Twyne's Case*, and the presumptive secrecy of the transaction in *Clow*, appear to have been as troubling as any ill intent in either to evade creditors.

Recordation systems appear to have developed, in part, as an informational proxy for possession which could deter or correct the problems of fraudulent conveyances and secret liens. Although these systems existed even before the American Revolution,[62] they began to flourish later, in the early part of the nineteenth century with a view to preventing or remedying problems like those in *Twyne's Case*.[63] Recording was viewed as a means of deterring the actual or constructive fraud presumed to be at the heart of the non-possessory property interest.[64] To the extent that fraudulent conveyances were a transgression of community norms, the compulsory disclosure of information became a method of regulating that which the community could not.

These systems bloomed with the industrial revolution and its insatiable appetite for liquidity. As Professor Gilmore explained:

> The unprecedentedly rapid expansion of industrial facilities created an equally unprecedented demand for credit. The financing institutions which were the source of credit naturally desired security for the loans . . . . As industrialization progressed, personal rather than real property came to be the principal repository of wealth. The mortgage on Blackacre would no longer be enough to support the merchant's insatiable demand for credit and the banker's demand for security. Nor would the medieval institution of pledge suffice to take up the slack of . . . [industrial] property which could not be pledged because it had to be used in the borrower's business . . . . The story of how the equipment and the rolling stock and the stock in trade came to be available as collateral is essentially the story of personal property security law in the nineteenth century.[65]

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62 *See id.* at 363 n.5; *see also* George Lee Flint, Jr., *Secured Transactions History: The Impact of Textile Machinery on the Chattel Mortgage Acts of the Northeast*, 52 OKLA. L. REV. 303 (1999); George Lee Flint, Jr., *Secured Transactions History: The Northern Struggle to Defeat the Judgment Lien in the Pre-Chattel Mortgage Act Era*, 20 N. ILL. U. L. REV. 1 (2000). Professor Flint has recently argued that concerns about secret liens may have influenced legislatures enacting chattel mortgage acts before the Industrial Revolution. *See* George Lee Flint, Jr. & Marie Juliet Alfaro, *Secured Transactions History: The First Chattel Mortgage Acts in the Anglo-American World*, 30 WM. MITCHELL L. REV. 1403, 1450-51 (2004).

63 *See* GILMORE, *supra* note 8, §§ 2.1-2.2, at 25-27 (discussing history of chattel mortgage acts as response to problems of fraudulent conveyance). *Compare* Flint, *Fraudulent Myth*, *supra* note 61, at 367 ("This study importantly eliminates Gilmore's implication of the nonpossessory secured transaction as a fraudulent transaction."). For purposes of this Article, it is not necessary to resolve whether nonpossessory secured transactions were or were not fraudulent. The ultimate questions are why public notice systems took hold and whether they continue to make sense.

64 GILMORE, *supra* note 8, §§ 2.1-2.2, at 25-27.

65 *Id*. § 2.1, at 25. Of course, Professor Gilmore also observed that the same pressures that led to a wide variety of complex alternatives to the pledge were not replicated in England, where

These developments presented policy makers with a choice. On the one hand, they could do nothing, and tolerate the growing likelihood that creditors and other potential investors would be duped by the potentially misleading appearance that property in fact belonged to the possessor. They might then take refuge in the possibility that merchant communities would develop methods of communication that would reliably distribute this information.[66] Alternatively, they could establish systems to force this information into the public domain. To a significant degree, they chose the latter.[67]

Yet, if policy makers chose to force merchants and financers to disclose nonpossessory interests in personal property through public notice systems, they did not—at least initially—appear concerned with the efficiency or simplicity of such systems.[68] Rather, while growing industrialization in the nineteenth century may have sought increasingly efficient methods of creating liquidity, it would appear that commercial finance statutes of that era were anything but simple. First, the recording systems did not, strictly speaking, require notice filing.[69] Rather, being rooted in the real property recordation systems, they usually called for the recording of elaborate documentation, including the filing of the mortgage itself and sometimes ancillary materials, such as affidavits and acknowledgments of good faith and consideration.[70] These additional documents were, in Professor Gilmore's estimation, "self-serving," and reflected "the deep-rooted nineteenth century suspicion that a [non-possessory] mortgage on personal property was in all probability a species of fraudulent conveyance."[71]

Second, because there were several different independent security devices, there were several different independent recording systems.[72]

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commercial needs were addressed "in an altogether simpler fashion." *Id.*

66 One example of this might be the posting of signs indicating the presence of a factors' lien, a phenomena discussed *infra* in notes 73-78 and accompanying text.

67 The author notes parenthetically that at least one other factor likely motivated policy makers at this time: raising revenue. As discussed in part III.B.1, *infra*, a number of writers have argued that many of the more formal information systems designed to solve the problem of secret liens were in whole or in part tax schemes. *See, e.g.*, Mooney, *Myth*, *supra* note 33, at 726 n.162 (citing 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 61b-c, at 89-93 (rev. ed. 1940)).

68 *See* GILMORE, *supra* note 8, § 15.2, at 466.

69 *See id.*

70 *See, e.g.*, *id.*; Coogan, *supra* note 8, at 291.

71 GILMORE, *supra* note 8, § 15.2, at 466.

72 *See id.* § 15.1, at 463 ("The typical pre-Code pattern included separate filing systems for chattel mortgages, for conditional sales, for trust receipts, for factors' liens, and for assignments of

Because lenders frequently had to engage multiple security systems, they had to comply with multiple notice systems. While this would presumably have increased the incidence of innocent mistakes, it is not apparent that it resulted in more or, more importantly, better information on which creditors and other investors could rely.

This tendency to confuse quantity of information with quality persisted into the early twentieth century, reaching an apex of sorts with the enactment of the factors' lien acts. These acts often required both notice filing and the posting of signs on debtors' doors. The prototype for this type of law was the New York Factors' Lien Act,[73] enacted after some political skirmishing in 1911.[74] As enacted, the law provided:

> Liens upon merchandise or the proceeds thereof created by agreement for the purpose of securing the repayment of loans . . . made upon the security of said merchandise . . . shall not be void or presumed to be fraudulent or void as against creditors or otherwise, by reason of want of delivery to or possession on the part of the lienor, whether such merchandise shall be in existence at the time of the creation of the lien or shall come into existence subsequently thereto . . . provided there shall be placed and maintained in a conspicuous place at the entrance of every building . . . at which such merchandise . . . shall be located . . . a sign on which is printed . . . the name of the lienor and . . . provided further that a notice of the lien is filed . . . .[75]

Duplicative notice—filed and posted—was justified on informational grounds. In support of the Factors' Lien Act, Assemblyman (later

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accounts receivable.").

[73] N.Y. SESS. LAWS 1911, ch. 326, § 1, amended by N.Y. SESS. LAWS 1931, ch. 766; N.Y. SESS. LAWS 1935, ch. 690; N.Y. SESS. LAWS 1943, ch. 635; N.Y. SESS. LAWS 1954, ch. 594, as amended, N.Y. PERS. PROP. LAW § 45 (1954).

[74] The Factors' Lien Act was initially vetoed in 1910, the year it was introduced in New York. *See* Robert M. Zinman, *Dominion and the Factor's Lien: Does Section 45 of the New York Personal Property Law Abrogate the "Dominion Rule"?*, 30 FORDHAM L. REV. 59, 70 (1961). The history of the initial veto and subsequent modification and enactment of the Factors' Lien Act is somewhat confused. Peter Coogan indicates that Governor Charles Evans Hughes vetoed the legislation because it lacked a provision requiring sign posting. Coogan, *supra* note 8, at 294 n.8. Professor Zinman and several other authors he cites suggest the Act originally contained only the sign posting requirement and not the additional requirement of notice filing. *See* Zinman, *supra*, at 68. The weight of authority would appear to be on Professor Zinman's side. See *id.* at 68 n.51. In any case, the important point is not the legislative history of the Act, but how public notice may or may not solve property information problems, like those of secret liens. Problems with sign posting and the factors' liens acts in general are discussed in a symposium issue of *Law and Contemporary Problems*. *See* Symposium, *Secured Commercial Financing*, 13 LAW & CONTEMP. PROB. 553 (1948).

[75] N.Y. SESS. LAWS 1911, ch. 326, § 1.

Governor) Alfred E. Smith argued, "[a]ll that the bill does is to substitute public notice for actual possession of the goods."[76] Notice—by filing and sign posting—was, in Smith's words, "a form of constructive possession of the goods."[77] If one believed possession was a meaningful method of conveying information about property, one might then accept the idea that notice filing was at least as effective.[78]

Factoring is a good example of how notice filing became proxy for information a community might otherwise have generated about a debtor's property. Factoring began as a form of consignment sales transaction:[79] Remote manufacturers, often garment makers, would deliver goods to factors in the cities, who would sell the goods and remit proceeds to the manufacturer.[80] So long as the factor had possession, it appeared the factor also had a lien.[81] Problems arose for factors, however, when the manufacturers began to retain possession of their finished goods in warehouses they owned or leased in the sales markets, while factors continued to provide financing, principally by purchasing the receivables that would be generated when the merchandise was sold.[82] Without possession of the goods, the factor would lose its common law lien.

Because these transactions were not covered by the recording statutes then in force, the parties had to develop some way to establish the factor's nonpossessory lien on the manufacturer's goods in the event the manufacturer went bankrupt. The method chosen by the community of factors and merchants was sign posting. For example, in *Ryttenberg v. Shefer*,[83] a case that arose before enactment of the Factors' Lien Act, the parties assigned the manufacturer's warehouse lease to the factor, and a sign was posted at the entrance to the storage floor, indicating that the

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76 Zinman, *supra* note 74, at 70 (citations omitted).

77 *Id.*

78 *See supra* notes 38-43 and accompanying text.

79 *See* Herbert R. Silverman, *Factoring: Its Legal Aspects and Economic Justifications*, 13 LAW & CONTEMP. PROB. 593 (1948). Silverman has suggested that, broadly understood, factoring well preceded the law of the United States and was apparently part of Roman commerce. *See id.*

80 *See id.* Factors differed from brokers because the factor was said to be entrusted with the merchandise and would apparently absorb the loss in the event the customer ultimately failed to pay. *Id.* (citing PARONS ON CONTRACT 100 (5th ed. 1905)).

81 *See* Zinman, *supra* note 74, at 65 (citations omitted); *see also* Kruger v. Wilcox, Ambler 252, 27 Eng. Rep. 168 (Ch. 1755) (holding at common law that factor had a general lien on the goods and products of his principal in the factor's possession). The common law possessory lien was later enacted by the New York Legislature as N.Y. SESS. LAWS 1830, ch. 179.

82 Zinman, *supra* note 74, at 66-67.

83 131 Fed. 313 (S.D.N.Y. 1904).

premises had been "annexed" to the factor.[84] Despite expert testimony to the effect that this was the industry's way of giving public notice of a factor's lien, the court concluded the sign was "indecisive" because the premises did not in law belong to the factor, and therefore the factor could have been barred by injunction from the premises.[85]

Cases like *Ryttenberg* called for a legislative response, which came in the form of the Factors' Lien Act.[86] As noted earlier, New York may have been willing to permit factors to retain nonpossessory liens on merchants' inventory, but only if public notice of the interest was given.[87] Sign posting was one way this notice was to be given. Yet, sign posting was not, by itself, apparently sufficient notice of the property interest in question. As originally proposed, the Factors' Lien Act required only sign posting and not the additional step of notice filing.[88] For this reason, Charles Evans Hughes, then-governor of New York,[89] vetoed it in 1910.[90] Without notice filing, he said, the Factors' Lien Act "'would . . . facilitate secret liens and fraudulent transactions.'"[91] Once notice filing was added, Hughes signed the bill into law.[92]

Sign posting as required by the Factors' Lien Act would have a short shelf-life as a method of conveying property information in commercial finance transactions. In 1954, New York amended the Factors' Lien Act to eliminate the sign posting requirement.[93] The reasons for eliminating sign posting would sound familiar to us today. The proponent of the amendment, Assemblyman Stanley Steingut, argued that sign posting was "completely old-fashioned, in that it presupposes that credit grantors make a personal examination of the premises of the credit seeker. As a

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[84] *Id.* at 320. The sign stated, "Shefer, Schramm & Vogel, Annex." *Id.* Shefer was the factor. *Id.*

[85] *Id.*

[86] N.Y. SESS. LAWS 1911, ch. 326, § 1, amended by N.Y. SESS. LAWS 1931, ch. 766; N.Y. SESS. LAWS 1935, ch. 690; N.Y. SESS. LAWS 1943, ch. 635; N.Y. SESS. LAWS 1954, ch. 594, as amended, N.Y. PERS. PROP. LAW § 45 (1954).

[87] *See supra* notes 73-77 and accompanying text.

[88] *See* Silverman, *supra* note 79, at 599.

[89] From 1930 to 1941, Hughes served as Chief Justice of the Supreme Court. *See* 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 1383-84 (3d ed. 2000).

[90] *See* Silverman, *supra* note 79, at 599.

[91] *See id.* (quoting Veto Memorandum of Charles Evans Hughes, Governor of New York (June 25, 1910)) (citations omitted).

[92] *Id.*; *see also* discussion *supra* note 74.

[93] N.Y. SESS. LAWS 1954, ch. 594.

matter of fact, credit grantors rely upon financial statements and upon credit reports issued by . . . credit agencies . . . ."[94]

This suggests community norms about the generation of information have historically been important in deciding what information should be conveyed and how. While sign posting may at one time have conveyed important signals about relationships between things and people, it became increasingly clear the sign told the community little of value. The sign became, in Professor Zinman's words, a "superfluous nuisance."[95] Worse, while it may have provided little useful information to the merchant community, it did give information to others who may have had no legitimate reason to know about the debtor's finances, such as customers, competitors, and employees.[96] And, of course, there was always the possibility that the unscrupulous debtor might remove the sign on the eve of bankruptcy, thereby exposing the lender to the risk that it would effectively lose its entire property interest.[97] The sign, like possession before it, was a temporary impediment to the development of richer, and more complex, commercial relationships.

2. *Notice Filing*

While sign posting may have withered away, notice filing survived. Indeed, it flourished and continued to abstract away from the real property recordation model which preceded it. The Uniform Trust Receipts Act,[98] promulgated in 1933, "popularized the idea that for certain kinds of transactions," such as those involving inventory or accounts receivable,

> it is not essential for all of the details of the transaction to be spread upon the public record so long as the record gives an indication where an interested party might inquire to learn whether or not particular collateral of the indicated class or type is subject to the perfected security interest.[99]

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94 Zinman, *supra* note 74, at 83 n.117.

95 *Id*. at 83.

96 *See id.*

97 *See id.*

98 UNIF. TRUST RECEIPTS ACT, 9C U.L.A. 665 (1943).

99 Coogan, *supra* note 8, at 314-15 (footnote omitted). The Uniform Trust Receipts Act, promulgated by the National Conference of Commissioners on Uniform State Laws in 1933, permitted the filing of a "statement of trust receipt financing" of the following form:

> The entruster, whose chief place of business within this state is at, [or who has no place of business within this state and whose chief place of business outside this state is at] is or expects to be engaged in financing under trust receipt transactions the acquisition by the

The drafters of the UCC picked up on this theme. Until recently, notice filing was the near-universal means of rendering a nonpossessory security interest in personal property enforceable against third parties.[100]

Today, when notice is required, it will be given in one of two general ways. If some registry already exists with respect to the type of property in question, Article 9 "steps back" to require that notice of the security interest in that type of property be perfected by giving notice in the existing registry.[101] But where another registry does not exist—and that may well be true much of the time—the security interest will be perfected by filing a UCC-1 financing statement in the state of the debtor's location.[102] The UCC-1[103] is a simple form—paper or electronic—that

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> trustee, whose chief place of business within this state is at of goods of the following description:
>
> [coffee, silk, automobiles, or the like.]
>
> [Signed] *Entruster*
>
> [Signed] *Trustee*.

U.T.R.A. § 13(2). This form can be seen as an ur-UCC-1, a simple notice of the pre-UCC equivalent of the non-possessory security interest.

[100] *See* GILMORE, *supra* note 8, § 15.1, at 463 ("As nonpossessory security interests become more familiar, filing comes to be looked on not merely as an alternative to possession but as the exclusive method of perfection."); *see also* William C. Hillman, *What's in a Name: The U.C.C. Filing System in the Courts*, 44 OKLA L. REV. 151 (1991) ("[T]he primary method of perfection [under former Article 9 was] by the filing of a financing statement."). The rules on notice in prerevision Article 9 appeared principally in UCC §§ 9-401 through 9-407 (2000).

[101] *See* U.C.C. §§ 9-310(a); 9-311(a)(1) (2003). UCC § 9-311 provides that a financing statement is not "effective to perfect a security interest in property subject to . . . a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property . . . ." This provision preempts the general rule contained in § 9-310 that a financing statement must be filed to perfect a security interest.

The Official Comment to UCC § 9-311(a) explains that an example of such a statute is 49 U.S.C. § 44107 (2000), for civil aircraft. Section 44107 establishes "a system for recording . . . conveyances that affect an interest in civil aircraft of the United States" including "leases and instruments executed for security purposes, including conditional sales contracts, assignments, and amendments." 49 U.S.C. § 44107(a). Other federal statutes that might preempt Article 9's filing system include the Ship Mortgage Act, 46 U.S.C. § 31343, and federal law governing security interests in rolling stock, 49 U.S.C. § 11301(a). *See* Drabkin v. Cont'l Ill. Bank & Trust Co. (*In re* Auto-Train Corp.), 9 B.R. 207 (Bankr. D.D.C. 1981).

An especially important category of collateral here will be copyright and perhaps other types of intellectual property. *See* Jonathan C. Lipson, *Financing Information Technologies: Fairness and Function*, 2001 WIS. L. REV. 1067, 1104-22 [hereinafter Lipson, *Information Technologies*]; Jonathan C. Lipson, *Remote Control: Revised Article 9 and the Negotiability of Information*, 63 OHIO ST. L.J 1327 (2002) [hereinafter Lipson, *Remote Control*]. As discussed *infra*, notes 166-169 and accompanying text, the recent decision in *In re World Auxiliary Power*, 303 F.3d 1120 (9th Cir. 2002), provides some clarity about the scope of federal law in this context, but may also create other problems.

[102] U.C.C. §§ 9-301, 9-307, 9-310, 9-501 (2003). Generally speaking, a corporate, or other "registered organization," debtor will be "located" in its state of formation (e.g., a Delaware

sets forth the debtor's name, the secured party's name, and a brief description of the property subject to the security interest.[104] The financing statement may also set forth certain other items of information about the debtor, including its organizational type, identification number (if any), and its address.[105]

The UCC-1 financing statement is most decidedly not a property recordation device, as might be found in the real property or intellectual property contexts. Strictly speaking, the properly filed financing statement neither creates the security interest nor even assures the world that such an interest has in fact been granted.[106] Rather, the filed financing statement is intended to put searchers on "inquiry notice" of the possible existence of a security interest.[107] It is thus not surprising that the rules on describing collateral in the financing statement are moderately flexible. Collateral may be described by, among others, "specific listing," "category," "type," or "any other method, if the identity of the collateral is objectively determinable."[108]

While the financing statement may not be a granting instrument, it is nevertheless the document that gives the security interest its true force as "property," that is its universal effectiveness against most challengers.

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corporation is located in Delaware, even if it has no physical presence in that state). *Id.* § 9-307 (2003); *see* Lynn M. LoPucki, *The Article 9 Filing System: Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577 (1995).

103 A copy of the UCC-1 form is set forth in Annex A.

104 U.C.C. §§ 9-503, 9-521.

105 *Id*. § 9-516(b).

106 Rather, as any survivor of a basic class on secured credit can tell you, the interest is "created" by the "attachment" of the security interest, a state of affairs that exists if a debtor has received value (e.g., a loan), has rights in the collateral (e.g., owns it) and has contracted to grant the security interest. *See id.* § 9-203(a).

107 *Id*. § 9-502. "What is required to be filed is . . . only a simple record providing a limited amount of information," the official comment to UCC § 9-502 provides. *Id*. § 9-502, cmt. 2. "The notice itself indicates merely that a person may have an interest in the collateral indicated. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs." *Id.*

108 *Id*. § 9-108(b). Strictly speaking, the rules governing the description of collateral in a financing statement are set forth in UCC § 9-504, where the operative term is, confusingly enough, described as "indication." For a financing statement to be effective, it must "indicate" the collateral, UCC § 9-502(a)(3), which may either be a "description" that comports with UCC § 9-108 or an "indication" that the financing statement covers "all assets" of the debtor. *Id.* § 9-504(2). The distinction between "description" and "indication" is attributable not to concerns about secret liens, but instead to the mechanics of creating a blanket lien (all assets security interest). *See id.* § 9-504(2) & cmt. 2 (2003). While a financing statement may, as noted, be effective merely by indicating a security interest in "all assets," UCC § 9-108(c) forbids such "supergeneric" descriptions in the security agreement if it purports to take a security interest in all or substantially all of a debtor's property. *Id.* § 9-108(c) & cmt. 2 (commenting that an "'all assets' or 'all personal property' description for purposes of a *security agreement* is *not* sufficient").

The financing statement system may thus be seen as an articulation of the link between property rights and notice obligations that arises when other means of gathering information about a debtor (e.g., its community) are unavailing. As Douglas G. Baird and Thomas H. Jackson have observed, "[notice f]iling systems work because the legal rules provide not only a benefit to a person who desires to acquire a property right but also a corresponding responsibility. One is obliged to stake one's claim in the filing system so that future parties will be able to find it."[109]

Ironically, it appears that the true force of notice filing has come not from its informational value but from its in terrorem effect, i.e., the penalty imposed on the secured creditor whose notice is defective. This is because a trustee for a debtor that has sought bankruptcy protection may exploit these defects by avoiding transactions in which notice is flawed.[110] If the transaction is avoided, the property becomes part of the debtor's estate effectively free of the security interest[111] and is then available for redistribution to all of the debtor's stakeholders (e.g., general creditors).

This power, sometimes called the "strong-arm power," is rooted in concerns about the problem of secret liens.[112] In 1910, Congress amended the Bankruptcy Act then in force to expand a bankruptcy trustee's avoidance powers.[113] Congress was concerned that cases like *York Manufacturing Co. v. Cassell* paralyzed bankruptcy trustees trying to recapture for the estate property that had been conditionally assigned in unrecorded transactions.[114] In response to *York*, Congress amended the Bankruptcy Act to provide that bankruptcy trustees "shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings . . . ."[115] Congress reasoned that an "unrecorded instrument [of conveyance] . . . which would have been void in the state courts had the property been . . . levied upon by attachment or

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109 Baird & Jackson, *Uncertainty*, *supra* note 23, at 312.

110 *See* 11 U.S.C. § 544(a)(1) (2000).

111 *Id.* §§ 541, 551.

112 It was needed, Congress indicated, "to prevent the evil of secret liens." 61 CONG. REC. 2275 (1910).

113 *See* H.R. REP. NO. 61-511, at 6-7 (1910).

114 201 U.S. 344, 352 (1906). The Court reasoned in *York Manufacturing* that because the bankruptcy trustee "stands simply in the shoes of the bankrupt . . . he has no greater right than the bankrupt." *Id*. Having no greater rights in machinery that was conditionally assigned to the "unperfected" seller in that case, the trustee was unable to recover the property for the benefit of the debtor's other creditors. *Id.* at 353.

115 Act of June 25, 1910, ch. 412 § 8, 36 Stat. 838, 840.

execution from a state court" should be ineffective ("void") as against a bankruptcy trustee.[116]

Eradicating secret liens remains the goal of the strong-arm power. Thus, the 1973 Report of the Commission on Bankruptcy Laws of the United States, which led ultimately to the Bankruptcy Code, observed, "[o]ne of the essential features of any bankruptcy law is the inclusion of provisions designed to invalidate secret transfers made by the bankrupt prior to the date of the filing of petition."[117] Although the Bankruptcy Code has been through several major revisions since the early part of the twentieth century, the strong-arm power remains essentially intact and is today found in § 544(a)(1).[118]

If deterring the creation of secret interests in a debtor's property was the purpose of the strong-arm power, one might think that merely technical failures in notice, which did not meaningfully impair the quality of the notice actually given, would not expose the transaction to avoidance. That is, to the extent notice was actually given, the transaction should be good against the bankruptcy trustee because the transaction was no longer "secret."

That, however, is not the way avoidance law developed. Case law under the strong-arm power is replete with instances of secured parties losing their security interests for reasons that appear, in retrospect, to have been nit-picky, at best, and capricious, at worst.[119] Initially, it was thought these injustices could be attributed to the arcane statutes that governed secured transactions prior to general enactment of the UCC.[120]

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[116] 61 CONG. REC. 2271.

[117] *See* Commission on the Bankruptcy Laws of the United States, H.R. REP. NO. 93-137, at 18 (1973).

[118] *See* 11 U.S.C. § 544(a)(1) (2000). Section 544(a)(3) gives the bankruptcy trustee the rights and powers of "a bona fide purchaser of real property . . . from the debtor, against whom applicable law permits such transfer to be perfected." *Id.* § 544(a)(3). This section differs from § 544(a)(1) in several respects, including that it implies in law that the trustee has the rights of a "bona fide purchaser." Ordinarily, lien creditors (i.e., the bankruptcy trustee under § 544(a)(1)) are not "bona fide purchasers." *See, e.g.*, U.C.C. § 1-201(32) (2003) (defining "purchase" to exclude "involuntary" conveyances such as those involving lien creditors).

[119] *See* Lipson, *Information Technologies*, *supra* note 101; James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOYOLA L.A. L. REV, 823, 837-38 (1993) [hereinafter White, *Wasteful Litigation*].

[120] *See* Coogan, *supra* note 8, at 319 ("The secured party has had a rough time with the filing systems of pre-Code chattel security law. Decision after decision, to say nothing of the statutes themselves, has disregarded the real function of a filing or recording system–namely, to give notice to other creditors of the actual or possible existence of security interests in property which appears to be owned by the debtor."). *See generally* David Gray Carlson, *Debt Collection as Rent Seeking*, 79 MINN. L. REV. 817, 834 (1995) [hereinafter Carlson, *Debt Collection*] ("It cannot be denied . . . that debtor's counsel and bankruptcy judges exalt in hanging a secured creditor out to dry for the most

The great formalities that attended pre-Code law created ample opportunities for aggressive trustee's counsel.[121] Even under the UCC, trustee's counsel has been able to exploit seemingly innocuous footfaults in the notice given. Mistakes in the debtor's name,[122] descriptions of collateral,[123] or the place of filing[124] have all been used against the secured party.

It is not clear how these uses of the strong-arm power support the informational goals of notice filing. If, as may well have been true in many of these cases, the community of creditors knew or had reason to know the debtor's property was encumbered, it is not clear that a minor error in the debtor's name or collateral description created a secret lien, perpetrated a fraud, or otherwise violated norms of the applicable merchant community. It may be that the strong-arm power is a necessary evil, exerting in terrorem force over creditors, compelling them—as the *Clow* court suggested—to "leave nothing unperformed, within the compass of their power, to secure third persons from the consequences of the apparent ownership of the vendor."[125] But simply asking lenders to do more does not necessarily assure that anyone else will have a meaningful understanding of what the debtor does or does not have.

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inconsequential mistakes.").

[121] Some of the older cases are collected by Coogan, *supra* note 8, at 291 n.5 (citing Amberson Inv. Corp. v. Fitzgerald, 266 F.2d 767 (10th Cir. 1959) (recorded mortgage failed to recite maturity date of secured note); *In re* Urban, 136 F.2d 296 (7th Cir. 1943) (absence of affidavit); *In re* Int'l Harvester Co., 9 F.2d 299 (6th Cir. 1925) (copy of affidavit insufficient); *In re* Prod. Aids Co., 193 F. Supp. 180, 185 (S.D. Iowa 1961) (failure to indicate corporate authority to sign); *In re* Leven, 42 F. Supp. 484 (D. Md. 1941) (failure of affiant to disclose agency status); *In re* Holley, 25 F.2d 979 (N.D. Iowa 1928) (failure to disclose title of subscribing notary); Nordman v. Rau, 119 Pac. 351 (Kan. 1911) (purchaser not bound by knowledge of faulty mortgage); Sickinger v. Zimel, 77 A.2d 905 (N.J. 1951) (false recital of consideration)). *See also* R.I. Hosp. Nat'l Bank v. Larson, 79 A.2d 182 (Conn. 1951) (failing to specify day when monthly payments were due).

[122] *See, e.g.*, *In re* Tyler, 23 B.R. 806 (Bankr. S.D. Fla. 1982) (filing against "Tri-Molded Plastics, Inc." ineffective where debtor's name is "Tri-Moulded Plastics, Inc."); ITT Commercial Fin. v. Bank of the W., 166 F.3d 295 (Tex. 1999) (filing against "Compucentro, USA, Inc." ineffective where debtor's name is "Compu-Centro, USA, Inc.").

[123] *In re* K.L. Smith Enters., Ltd., 2 B.R. 280 (Bankr. D. Colo. 1980) (laying hens were "livestock," not "equipment" or "inventory"); *see In re* Northeast Chick Serv., Inc., 43 B.R. 326 (Bankr. D. Mass. 1984) (finding chickens were "farm products," not "inventory").

[124] Perhaps the leading candidate here is *In re Peregrine Entertainment, Ltd.*, 116 B.R. 194 (Bankr. C.D. Cal. 1990), which held that, even though the secured party filed effective UCC-1 financing statements, its security interest in the debtor's library of copyrighted films and the proceeds from those films (royalties) was not perfected because it was not recorded in the Copyright Office. *See* Lipson, *Information Technologies*, *supra* note 101, at 1071 (lamenting unfairness of apparent arbitrariness of perfection rules as applied to information technology collateral).

[125] Clow v. Woods, 5 Serg. & Rawle 275, 281 (Pa. 1819).

At bottom, it would appear notice filing systems developed at least in part as proxy for the information that would otherwise have been readily available in simpler, community-based information systems (e.g., systems that recognized only possessory liens). Information-forcing systems such as the UCC-1 were a response to certain types of community transgressions—those that involved secret interests in property. The strong-arm power may then be seen as a blunt information-generating tool, more troublesome for its over- and under-inclusiveness than for its basic goals. It is, however, our response to the fact that, in a world with increasingly complex and fragmented community structures—or none at all— "creditors need to verify their claims."[126]

C. Modern Systems: Private Credit Reporting and Contract

There is something vaguely quaint about a system that purports to establish information about nonpossessory interests in personal property through the filing of slips of paper in the offices of various public officials (e.g., secretaries of state).[127] Indeed, the implausibility of such a system forms the basis for one of the arguments against the continued use of the notice filing system.[128] There are undoubtedly those who view the financing statement system as little better than the posted sign under the Factors' Lien Act.

The truth is that we have a poor understanding of the purpose that notice filing currently serves. It is tempting to view notice filing as vestigial, however, because we know the information that is likely to be most important to a community of creditors will derive from either or both of two "private" sources: (i) information intermediaries, like Dun & Bradstreet, who provide analyses of companies as to such matters as timeliness of payment, credit history, and so on[129] and/or (ii) contract and due diligence.

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126 Alces, *supra* note 3, at 680; *see* Peter A. Alces & Robert M. Lloyd, *An Agenda for Reform of the Article 9 Filing System*, 44 OKLA. L. REV. 99 (1991) (noting the UCC-1 system is "the very foundation of the personal property security law in the United States") (footnote omitted).

127 Of course, Article 9 is "medium neutral" in certain respects and permits the electronic filing of financing statements. *See* U.C.C. §§ 9-516(a) (discussing rules for effective "communication" of financing statements); 9-102(a)(18)(C) (defining "communicate" to include electronic transmission, if permitted by filing office rules); 9-102 cmt. 9.a. (discussing medium neutrality and electronic notice filing).

128 These and other objections were gathered in a *Minnesota Law Review* symposium cited *supra* at note 6 and discussed *infra* in Part III.B.

129 In its own words:

> D&B manages the world's most valuable commercial database with information on 83

Consider first the information intermediaries. Firms like Dun & Bradstreet provide enormous databases of information, including credit information about thousands of businesses, which is available to potential creditors or litigants for a price.[130] One might think these systems would be of greater value to the community of likely creditors than the filed financing statement, which is, at best, only suggestive of the existence of nonpossessory property interests. This is consistent with Professor Lynn LoPucki's view that unsecured creditors often "cash-flow" surf and gather information about their debtors through a variety of private and informal channels.[131] According to LoPucki,

> if the debtor does not seasonably pay its unsecured creditors, that fact will be transmitted through credit reporting and other information channels to the debtor's secured creditors, employees, suppliers, customers and other trading partners. If the reports get bad enough, others will refuse to deal and the debtor will be unable to remain in business. In this conception, unsecured debt is likely to be short term and restricted to amounts that are small in relation to the creditor's portfolio. The unsecured creditor monitors the debtor through credit reports and other sources of information and evaluates the risk that the business will be discontinued.[132]

Yet, one component of Dun & Bradstreet and other similar analyses is an assessment of publicly recorded interests in the debtor's property, such as UCC-1 financing statements and judgment liens.[133] Other

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> million companies. Business information is gathered in 214 countries, in 95 languages or dialects, covering 181 monetary currencies. The database is refreshed one million times a day as part of our commitment to provide accurate, comprehensive information for our more than 150,000 customers.

Dun & Bradstreet, *Company Information*, *at* http://www.dnb.com/us/about/media/dnbcompanyinformation.html (last visited Apr. 11, 2005).

Information intermediaries are distinct in certain respects from the credit rating agencies, like Moody's and Standard & Poors—known technically as "nationally recognized statistical rating organizations"—because they tend to cover smaller companies who do not issue public securities. For a general discussion of the rating agencies, see, e.g., Schwarcz, *Complexity, supra* note 16. *See generally* Claire A. Hill, *Rating Agencies Behaving Badly: The Case of* Enron, 35 CONN. L. REV. 1145, 1146 (2003) ("Rating agencies rate companies and debt securities. They are critically important players in the capital markets."); Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004).

130 *See* Dun & Bradstreet, *D & B Products and Services*, *at* http://www.dnb.com/US/dbproducts/product_overview/index.html (last visited Apr. 11, 2005).

131 *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994) [hereinafter LoPucki, *Creditor's Bargain*].

132 *Id*. at 1941 (footnotes omitted).

133 As of January 2005, for example, Dun & Bradstreet's "information file inventory" housed 135,456,457 public records, including liens, *at* http://www.dnb.com/us/about/

services appear to look to similar types of information.[134] Perhaps the most explicit user of UCC financing statement information is Experian, which includes a "UCC Profile" in a company's report and lists up to ten of the most recent UCC filings (i.e., original filings, amendments, and/or terminations) with the most recent displayed first.[135] This suggests that even if creditors themselves do not look directly to the filed financing statement, the information intermediaries on whom they may rely do.

There appears to be a growing tendency to rely on these private information systems as proxy for information about property, even if that is not their principal function. In *In re Communication Dynamics, Inc*., for example, the Bankruptcy Court for the District of Delaware concluded that the review of a Dun & Bradstreet report was sufficient "notification" of the assignment of a claim to defeat a right of setoff, as provided in UCC § 9-404(a), which limits an account debtor's right to setoff against an account if the debtor (i.e., the account debtor's creditor) has assigned the account, and the account debtor has notice of it.[136] The account debtor in *Communication Dynamics* was deemed to have notice of the assignment of its account because a credit officer for the account debtor had obtained a Dun & Bradstreet report about the debtor indicating that a secured party had a lien on the debtor's accounts receivable.[137]

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db_database/dnbinfoquality.html.

[134] *See, e.g.*, InfoSource USA, *About Our Data*, *at* http://list.infousa.com/cgi-bin/abicgi/abicgi.pl?S53511741409690=bas_session&bas_elements=4&bas_vendor=190000&bas_type=LC&bas_page=6999&bas_action=AboutOurData (analyzing "secretary of state" information with respect to 14 million businesses it covers) (last visited Mar. 4, 2005).

[135] *See* Experian, *Sample Business Profile*, *at* http://www.experian.com/business/ page5.html (last visited Mar. 4, 2005).

[136] 300 B.R. 220, 225 (Bankr. D. Del. 2003).

[137] The court explained:

> [Account debtor] T & B argues that it did not receive an authenticated notice because third party private information providers, such as [Dun & Bradstreet], are not substitutes for the affirmative acts of signing or executing required of the assignee/assignor. The Debtor responds that a writing transmitted directly from a debtor or a secured party to an account debtor is not required to satisfy the authentication requirement of the statute. . . . Using this analysis, we conclude that the delivery of the [Dun & Bradstreet] report to T & B, which included a statement that the Lenders had a lien in all accounts receivable, meets this requirement. Such reports are often relied upon by parties in determining whether such liens exist. In fact, Mr. Burks testified that T & B does rely on [Dun & Bradstreet]'s comprehensive reports for information about its customers. Therefore, we conclude that, having received authenticated notice of the Lenders' liens on May 1, 2002, T & B's right to setoff does not have priority over the Lenders' liens under section 9-404 of the UCC.

Id. at 224-25. I note parenthetically that the *Communication Dynamics* opinion would appear to have erred in its interpretation of UCC § 9-404(a)(1). That section provides that the rights of an assignee (e.g., a secured party) are "subject to . . . any other defense or claim of the account debtor against the assignor [debtor] which accrues before the account debtor receives a notification of the assignment

Notice filing may provide part of the informational foundation on which these systems are built because all creditors may rely on them indirectly for information about credit decisions. Professor Mann's work tends to confirm this, indicating information asymmetries are often managed in the commercial world through a variety of—mostly informal—verification systems, including the use of private information intermediaries.[138] Thus, even if most unsecured creditors do not directly rely on the public record, the services upon which they rely for this information apparently do.

The same may be true of the role that contract and due diligence play in determining nonpossessory property interests. As noted *supra*, Baird and Jackson believe the financing statement should—and perhaps does—exist to allow secured parties to "stake claims" in a debtor's property.[139] A corollary to this would be that the system provides information about property that is relevant largely, and perhaps only, to this audience.[140] Yet they—or at least Baird—appear to believe that this information will be less important than other aspects of the credit decision.[141] Rather,

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authenticated by the assignor or the assignee." While the *Communication Dynamics* court discussed the meaning of the term "authentication," 300 B.R. at 225, it failed to recognize that a D & B report is not authenticated by the debtor. The mistake may have been in the court's assumption that financing statements are signed by debtors. *See id*. ("[W]e do not go so far as T & B in concluding that [UCC § 9-404(a)] means actual delivery of a signed copy of the financing statement . . . ."). Despite this obvious mistake, the court ultimately came to the correct result, recognizing that the account debtor retained a right of recoupment under UCC § 9-404(a)(1) because it received no authenticated notification from the debtor.

[138] *See, e.g.*, Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997); Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225 (1999) [hereinafter Mann, *Verification*].

[139] Baird & Jackson, *Uncertainty*, *supra* note 23, at 312.

[140] As Baird states,

> a secured creditor relies on particular assets of the debtor. He needs to know whether a particular piece of property is encumbered. If the property securing his debt is or might become encumbered, the creditor cannot consider the loan secured. The information that the Code provides secured creditors in its filing system is exactly tailored to their needs to know whether any claim they make to a particular asset will have priority over any other. The filing system is in effect a place where secured creditors stake claims to the debtor's property.

Baird, *Ostensible Ownership*, *supra* note 23, at 62 (footnote omitted).

[141] Baird makes two interesting, but unsupported, empirical claims about the role of information in secured lending. First, he argues, "many creditors know before they even meet their debtor that they will lend, if at all, on either a secured or unsecured basis." *Id*. at 66. Second, he argues,

> the usefulness of the information in the filing system does not derive from what it tells creditors who are just entering negotiations. At the early stages, creditors can rely on what their debtor tells them . . . . A lawyer usually does not even have the files checked until the deal is fairly far along, far enough, at any rate, for the decision to have been made

sophisticated creditors will make informational assessments by conducting "due diligence," whereby the debtor consensually shares information with the potential creditor. The lien search will confirm or deny the findings of due diligence.

It would be tempting to conclude that these private methods of learning about nonpossessory interests in property should wholly displace the notice filing system. Like possession and sign posting in older times, the claim would be that notice filing should give way to new and allegedly superior methods of distributing information about property. Yet doing so causes us to forget that notice filing developed as a proxy for community-based information (e.g., open, notorious, and peaceful possession) and would appear to remain an important, if indirect, component of modern information-generation methods. Part II describes three sets of transactions which would appear to display this sort of amnesia.

II. THE END OF NOTICE FILING: THREE SECRET LIENS

Neither the UCC nor any other legislative development wholly eliminates notice filing under all circumstances. Even the recent revisions to Article 9 of the UCC preserved, and in certain respects improved, the notice filing system to the extent it still applies. Yet, as a statutory matter, notice filing will have neither role nor effect in transactions involving increasingly important collateral, such as data, intellectual property, and bank and securities accounts. Moreover, securitization "facilitation" statutes have the potential to render notice filing entirely optional. With notice filing thus impaired, secret liens can, and perhaps should, flourish. This section summarizes how recent legislative developments tolerate, if not promote, the creation of secret liens.

A. Security Interests in Data and Intellectual Property: Rules on Proceeds and Continuity of Interest

A shallow reading of Article 9 of the UCC might lead to the conclusion that secret liens will be a rarity. UCC § 9-310(a) provides that perfection of a security interest presumptively requires the filing of a

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whether the loan will be secured."

Id. Either or both claims may be true—although I have my doubts—but no effort is made to substantiate them.

financing statement.[142] UCC § 9-310(b)(9), however, contains an important exception for security interests in "proceeds." Because revised Article 9 has greatly expanded the definition of proceeds,[143] its rules will often unwittingly create secret liens on data and intellectual property.[144]

There are at least three ways that a "proceeds" security interest might create secret liens. First, revised § 9-102(a)(64)(A) defines proceeds as including, among other things, "whatever is acquired upon the . . . license . . . of collateral."[145] This means that licenses of data or intellectual property, for example, should be "proceeds" of the original collateral, which may or may not have been data or intellectual property itself.[146] Second, UCC § 9-102(a)(64)(A) provides that the secured party may pursue proceeds in the hands of parties other than the debtor.[147] This means that, unless a license is "ordinary course," which is broadly nonexclusive, the security interest continues in both the original collateral and the proceeds, even as to third party licensees, sub-licensees, and so on.[148]

Third, UCC § 9-102(a)(64)(C) provides that proceeds include "rights arising out of collateral."[149] This cryptic phrase is not explained in the Official Comments to this section. It may, however, be quite expansive

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[142] U.C.C. § 9-310(a) (2003) ("Except as otherwise provided in subsection (b) and Section 9-312(b), a financing statement must be filed to perfect all security interests . . . .").

[143] Comment 13 to § 9-102 explains that "[t]he revised definition of 'proceeds' expands the definition beyond that contained in former Section 9-306."

[144] *See generally* Lipson, *Remote Control*, *supra* note 101 (discussing effect of rules on proceeds and continuity of interest on intellectual property and data).

[145] U.C.C § 9-102(a)(64)(A).

[146] *Compare In re* Transp. Design & Tech., Inc., 48 B.R. 635, 640 (Bankr. S.D. Cal. 1985) (declining to treat patent as proceeds of patent application under former Article 9), *with* Lipson, *Information Technologies*, *supra* note 101, at 1135-36 (questioning continued viability of *Transportation Design* rule in light of revised Article 9).

[147] Courts applying former Article 9 had come to this conclusion. *See, e.g.*, Centerre Bank, N.A. v. New Holland Div. of Sperry Corp., 832 F.2d 1415 (7th Cir. 1987); *In re* Guaranteed Muffler Supply Co., 1 B.R. 324 (Bankr. N.D. Ga. 1979); E. Idaho Prod. Credit Ass'n v. Idaho Gem, Inc., 842 P.2d 282 (Idaho 1992); First State Bank v. Clark, 635 N.W.2d 29 (Iowa 2001). There was, however, a split of authority on the issue. *See First State Bank*, 635 N.W.2d at 30 (discussing split). The Official Comment now emphasizes the point: "This Article contains no requirement that property be 'received' by the debtor for the property to qualify as proceeds." U.C.C. § 9-102 cmt. 13(d).

[148] Article 9 provides that, as a general matter, security interests continue in collateral notwithstanding sale, exchange or other disposition. U.C.C. § 9-315(a)(1). Security interests will be cut off, however, if such a transaction is in "ordinary course." *Id.* §§ 9-320 (ordinary course disposition of goods), 9-321 (ordinary course license of general intangibles). A license will only be "ordinary course" if, among other things, it is "non-exclusive" and in the ordinary course of the licensor's business. *See id.* § 9-321(a). *See generally* Lipson, *Remote Control*, *supra* note 101 (discussing continuity of interest rules).

[149] U.C.C. § 9-102(a)(64)(C).

and pick up all kinds of rights associated with original collateral, including intangible rights in technologies and data associated with original collateral.[150] I have argued elsewhere that if we take the statute seriously, this should mean that customer data is the proceeds of inventory, a patent is the proceeds of a trade secret, and a derivative work is the proceeds of a copyright.[151] In all cases, the later informational rights "arise out of" the earlier rights.

Putting perfection to one side for a moment, this is one reason security interests in data and intellectual property will subsist secretly. It is highly unlikely a debtor granting a security interest in one copyright, for example, understands that it is, as a matter of law, also granting a security interest in all derivative works it later produces. Similarly, and perhaps more importantly, it is unlikely a licensee of the derivative work, which also enjoys copyright protection, understands that it may be acquiring its interest encumbered by prior security interests.

The rules on the perfection of security interests in proceeds are complex, but the basic idea is that the security interest in proceeds will be perfected if the security interest in the original collateral was perfected[152] and any of three things is true: (i) The financing statement that was filed to cover the original collateral does, or could, cover the proceeds; (ii) the proceeds are cash or cash equivalents;[153] or (iii) the security interest in the proceeds becomes perfected in some other way.[154] It will be fairly easy to satisfy at least one of these requirements, especially when the collateral is data or intellectual property.[155] But satisfying these requirements does not

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150 *See* Lipson, *Information Technologies*, *supra* note 101, at 1132-38.

151 *Id*. The Copyright Act defines a "derivative work" as "a work based upon one or more preexisting works, such as a translation . . . art reproduction, abridgment, condensation, or any other form in which a work may be recast, transformed, or adapted." 17 U.S.C. § 101 (2000).

152 U.C.C. § 9-315(c).

153 Known technically as "cash proceeds," which are defined as "proceeds that are money, checks, deposit accounts, or the like." *Id.* § 9-102(a)(9).

154 *Id*. § 9-315(d).

155 Usually, it will be satisfied by the first alternative because data and intellectual property are general intangibles in which a security interest could be perfected by the filing of a financing statement. *See id.* §§ 9-310(a), 9-315(d)(1). This assumes that Article 9 applies at all. Article 9 defers entirely to other preemptive law (e.g., the federal law of copyrights) "to the extent that . . . a statute, regulation or treaty of the United States preempts [it]." *Id.* § 9-109(c)(1). It appears also to defer to the notice rules created by other legal systems if they make it possible for a secured party to obtain priority over a lien creditor by recording the security interest in the other system. *Id.* §§ 9-310(b)(3), 9-311(a)(1).

What this means for species of intellectual property subject to varying federal rules is a complex question. In the case of copyrights, for example, it was until recently thought the Copyright Act was wholly (or at least largely) preemptive of all of Article 9. *See* Lipson, *Information* necessarily mean that creditors are likely to know anything about the proceeds security interest.

Consider an example. Assume that *D* is an internet retailer of toys. *D* finances its inventory with money borrowed from *SP*. *SP* takes a security interest in *D*'s inventory, which *SP* perfects by filing a financing statement indicating a security interest in "inventory." Assume further, as is often the case, that when *D* sells toys in the ordinary course, it collects spending, demographic and similar information about its customers. Finally, assume that *D* sells or licenses its list of customer information to a data aggregator, *B/L*.

Presumably, *B/L* would believe it was acquiring its interest in this customer data free of the property claims of others. Even if *B/L* was highly diligent and conducted a lien search, it would only find a financing statement describing a security interest in "inventory," not "data" or "general intangibles"—the UCC label most likely to cover customer data.[156] But *SP* would have a perfected security interest in this data because the data is proceeds of the debtor's inventory, and there is no "good faith purchaser" rule that would apply to cut off *SP*'s security interest.[157] Thus, if *B/L* sold or licensed this list to others—even with *D*'s permission—the party that acquired the data from *B/L*, *B/L2*, would take the data subject to the same encumbrance. In this instance, it is virtually inconceivable that *B/L2* would be able to discover *SP*'s security interest, assuming *B/L2* even thought to look for it. It is not clear how the UCC-1 filed by *SP* as to *D* would put *B/L* or *B/L2* on notice of anything. A clean record with regards to *B/L2* would be false—*SP*'s secret lien would apparently survive and be enforceable against *B/L2*.

Technologies, *supra* note 101, at 1107-14 (discussing Nat'l Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass'n of Denver (*In re* Peregrine Entm't, Ltd.), 116 B.R. 194 (C.D. Cal. 1990)). More recent case law, however, suggests the Copyright Act will have preemptive effect only if the underlying copyright was registered with the Copyright Office. *See* Aerocon Eng'g v. Silicon Valley Bank (*In re* World Auxiliary Power Co.), 303 F.3d 1120 (9th Cir. 2002). As discussed *infra*, if this more recent case law survives, it means that it will be much easier to perfect a security interest in copyrights under Article 9, even if they would be undiscoverable by virtue of Article 9's perfection rules.

[156] *See* U.C.C. § 9-102(a)(42) (defining general intangibles); *see also* Lipson, *Information Technologies*, *supra* note 101, at 1122-32 (discussing data as general intangibles under the UCC).

[157] *See* U.C.C. § 9-321. This section provides that a "licensee in ordinary course of business takes its rights under a nonexclusive license free of a security interest in the general intangible created by the licensor, even if the security interest is perfected and the licensee knows of its existence." A "licensee in ordinary course of business" is defined as "a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind." *Id*. § 9-321(a); *see* Lipson, *Information Technologies*, *supra* note 101, at 1101.

The full magnitude of this problem is difficult to gauge. In theory, of course, it should mean that most data in the computers of most businesses is encumbered in ways, and by parties, not anticipated by the owners or users of the data. That said, should *SP* actually show up and claim the right to freeze or seize *B/L2*'s computer, *B/L2* should be expected to marshal a host of arguments, including that the data is not "property" capable of being encumbered under Article 9.[158] This argument seems a bit counterintuitive because *B/L2* probably treats the data as it would treat its other valuable property. In any case, the jury is out on the question of whether data is property for these purposes.[159]

A better argument might be one of impossibility. *SP* may have a security interest in the data, but *B/L2* would object, so too would a large number of unnamed, unidentified secured parties whose proceeds security interests all arose in more or less the same way. The statutory expression of this position would simply follow § 9-315(a)(2), which provides that the proceeds security interest continues only to the extent that it is "identifiable."[160] A more theoretical approach would rest on the observation that the proliferation of security interests would create a sort of "anti-commons," infecting data like a regenerating computer virus.[161] In either case, however, *SP* has significant potential leverage over a party with whom it has not dealt, *B/L2*, whose reasonable expectations surely would be defeated on these facts. Indeed, to the extent this is a problem of contract, it is unclear that *SP* could ever contract in a way to protect its expectations from this sort of problem. It would have to search too far back in too many chains to discover *SP*.

What if the problem involved intellectual property rather than data? Assume, for example, that *D* developed a data management software program which it licensed to *B/L*. Assume further that D's security agreement with *SP* includes general intangibles, the category that would

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158 *See* Lipson, *Remote Control*, *supra* note 101, at 1350-56.

159 *See* Edward J. Janger, *Muddy Property: Generating and Protecting Information Privacy Norms in Bankruptcy*, 44 WM. & MARY L. REV. 1801, 1840 (2003) (discussing property rights treatment of data).

160 UCC § 9-315(a)(2) provides that a security interest continues in "identifiable" proceeds without providing a definition of the term "identifiable." Although Article 9 provides no definition of "identifiable," it does state that non-goods proceeds (e.g., data) would be identifiable "to the extent that the secured party identifies the proceeds by a method of tracing, including applicable equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved." U.C.C. § 9-315(b)(2).

161 *See* Lipson, *Remote Control*, *supra* note 101, at 1410-11 (citing Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998)).

most likely describe intellectual property. The software would be subject to the Copyright Act which would, for certain purposes, preempt Article 9.[162] Until recently, there was some reason to believe the Copyright Act preempted all of the Article 9 rules on the perfection of security interests.[163] If so, *B/L* might have argued that unless the security interest was actually recorded in the United States Copyright Office, the security interest would have been unperfected. If unperfected (because undiscoverable in the copyright records), then presumably *B/L*'s rights would have had priority over *SP* under most circumstances.[164]

Recent case law, however, suggests that preemption will no longer protect the *B/L*s of the world if the underlying copyright is not registered.[165] In *In re World Auxiliary Power*, the debtor granted security interests in certain unregistered copyrights.[166] The bank filed UCC-1 financing statements as required by the UCC, but did not record the security interest with the Copyright Office.[167] The debtor's bankruptcy trustee attempted to sell the copyrights free of the bank's security interest, but the bankruptcy court sustained the bank's objections, finding the bank perfected its security interest in unregistered copyrights by filing and recording its security interest in accordance with Article 9 of the UCC.[168] The Ninth Circuit affirmed and held that federal copyright law does not preempt state law with respect to perfection and priority of security interests in unregistered copyrights.[169] "There is no reason to infer from Congress's silence as to unregistered copyrights," the court wrote, "an intent to make such copyrights useless as collateral by preempting state law but not providing any federal priority scheme for unregistered copyrights. That would amount to a presumption in favor of federal preemption, but we are required to presume just the opposite."[170]

Recording copyrights and registering security interests in them according to the scheme established by the Copyright Act would undoubtedly be a cumbersome, expensive, and time-consuming

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162 *See* Lipson, *Information Technologies*, *supra* note 101, at 1107.

163 *Id*. at 1107-14 (discussing the preemptive force of the Copyright Act).

164 UCC § 9-317(d) provides that a licensee or buyer of general intangibles (i.e., intellectual property) "takes free of a security interest if the licensee or buyer gives value without knowledge of the security interest and before it is perfected."

165 *See, e.g.*, *In re* World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002).

166 *Id*. at 1123.

167 *Id*.

168 *Id*. at 1124.

169 *Id*. at 1132.

170 *Id*. at 1131 (citations omitted).

proposition, one which I certainly have not advocated.[171] Nevertheless, it is important to see that whenever a security interest arises in a copyright, it will automatically arise in a license of that copyright. *In re World Auxiliary Power* makes it easier to perfect the security interest in both the original copyright and the license without actually giving meaningful notice, at least vis-à-vis remote parties. If the license is not ordinary course, the security interest will continue and the licensee may have no idea that it is taking its license subject to the prior interest of the licensor's secured party. As with data, the problem grows as intellectual property is sublicensed and subdivided, moving further and further away from the parties that initially created the encumbrance. While sublicensees may take subject to the security interest, it will, as it is with all secret liens, be difficult to discover ex ante.

The bottom line is that whole categories of increasingly important informational assets may be encumbered by secret liens. It should be noted that revised Article 9 is not entirely responsible for this state of affairs. Even prior iterations, which might have required notice more of the time, tolerated remote proceeds security interests, which effectively create secret liens.[172] Rather, the problems arise from expanding the definition of proceeds at precisely the wrong moment—when the universe of potential proceeds has expanded to include assets that happen to be highly mobile and mutable, such as data and intellectual property. Together these developments ensure a much larger universe of secret liens than we would intuitively expect commercial finance law to tolerate.

B. Control Security Interests

A second source of secret liens will arise by virtue of new rules concerning the creation of "control" security interests in bank and brokerage accounts. One of revised Article 9's major changes from prior law involves the use of control as a means of creating and perfecting a security interest. Generally speaking, a secured party will have control of certain types of collateral—deposit accounts, investment property, electronic chattel paper, or letter-of-credit rights[173]—if the secured party has the right to dispose of the property in question. Because control arises

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[171] *See* Lipson, *Information Technologies*, *supra* note 101, at 1107-14.

[172] Professor LoPucki catalogued ways that a debtor so inclined could fool creditors by secretly encumbering property while still complying with the prior (more notice friendly) version of Article 9. *See* Lynn M. LoPucki, *Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway*, 55 LAW & CONTEMP. PROBS. 5, 7-9 (1992).

[173] U.C.C. §§ 9-106, 9-104, 9-105, 9-107, 9-314(a) (2003).

solely by contract or operation of law, notice filing is either not required or not permitted.[174]

Although the statute does not make this distinction, there would appear to be two different kinds of control: bilateral and trilateral. Bilateral control involves two parties, such as a bank and a depositor/borrower. UCC § 9-104 automatically gives the secured party that is also a debtor's depositary bank a security interest in the account in question. Because security interests in deposit accounts as original collateral, not proceeds, may only be perfected by control,[175] the bank need not give notice of its security interest in the bank account.

Bilateral control has much in common with the right of setoff. Setoff says that a creditor may apply amounts it owes to a debtor to reduce the debtor's obligation to the creditor.[176] The classic examples involve bank accounts held at banks that also made loans to the borrower. Because a deposit account is simply a debt the bank owes the depositor, setoff permits the bank to apply the amount credited to the account—meaning owing to the debtor—against any amounts the debtor owes the creditor—meaning the loan the debtor is obligated to pay the secured party. Although the UCC does not generally govern the right of setoff, the right has often been characterized as a kind of equitable security interest.[177]

Bilateral control is distinct from trilateral control. Trilateral control occurs where the secured party is not also the entity that maintains the account. For example, a secured party has control of a deposit account if the depositary bank enters into an agreement—known as a control

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174 As to deposit accounts, filing was apparently considered and rejected early in the process of revising Article 9. *See* Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI-KENT. L. REV. 963, 983 (1999) (citing PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9: REPORT 70 (1992)).

175 U.C.C. § 9-312(b)(1).

176 *See In re* Communication Dynamics, Inc., 300 B.R. 220 (Bankr. D. Del. 2003).

177 *See id.* at 223 ("In essence, the right of setoff 'elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, pre-petition claim against the creditor.'") (quoting Univ. Med. Ctr. v. Sullivan (*In re* Univ. Med. Ctr.), 973 F.2d 1065, 1079 (3d Cir. 1992)).

Former UCC § 9-104 declared the article to be inapplicable to any right of setoff. However, rights of setoff are now expressly recognized currently at UCC §§ 9-306(d)(i) and 9-318(1) (2003). Whether a creditor seeking to assert a right of setoff must abide by Article 9's notice filing rules is unclear. In *In re Apex Oil Co.*, the court observed that "[w]hile we agree . . . that a bank or other creditor need not comply with Article 9 and its filing requirements to exercise its right to setoff, we do believe that Article 9 governs the priority between that right to setoff and a perfected security interest." 975 F.2d 1365, 1367-68 (8th Cir. 1992), *aff'd*, Apex Oil Co. v. Artoc Bank & Trust Ltd., 265 B.R. 144 (B.A.P. 8th Cir. 2001). That said, courts have also held a secured party that filed a financing statement will have priority over a bank asserting a later right of setoff. *See, e.g.,* Insley Mfg. Corp. v. Draper Bank & Trust, 717 P.2d 1341 (Utah 1986).

agreement—with the secured party that the depositary bank will comply with instructions from the secured party as to the funds in the deposit account, without further consent from the debtor.[178] As with bilateral control, trilateral control arises strictly by contract. Notice filing is neither permitted nor effective.

Control is justified as a method of perfection as to deposit accounts, investment property, and so forth because there is assumed to be a kind of community knowledge about the kinds of property in which a security interest may be perfected by control. "No other form of . . . notice is necessary" to perfect a security interest in a deposit account, the Official Comment tells us, because "all actual and potential creditors of the debtor are always on notice that the bank with which the debtor's deposit account is maintained may assert a claim against the deposit account."[179] Permitting perfection of a security interest by control therefore represents "a pragmatic judgment" by the drafters of revised Article 9 that these security interests are, in important respects, "public and unambiguous."[180]

Where there is "general knowledge" in an industry that certain kinds of property may be held subject to certain kinds of noncustodial claims (e.g., brokers always hold securities subject to the claims of other broker-dealers or lending institutions), it may be appropriate to dispense with public notice filing.[181] The "community" of banks and brokers knows or assumes that debtors' deposit and brokerage accounts are likely to be encumbered, therefore they could not possibly rely to their detriment on a "clean" lien search. There is presumed to be no "secret" because "everyone" knows.

But this begs the question, who is "everyone?" Consider an example. Assume that debtor, *D*, purchases an item of equipment with purchase-money financing from the vendor, *V*. Under UCC § 9-103, *V*

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178 U.C.C. § 9-104(a)(2).

179 *Id*. § 9-104 cmt. 3.

180 Schroeder, *Surrealism*, *supra* note 41, at 523-24.

181 *Cf. id.* at 522. Of course, on this logic, no filing or other public notice should ever be required because there is likely to be "general knowledge" about the kinds of borrowers that grant security interests in their assets and what kinds of assets those might be. Professor Schroeder does acknowledge that a security interest, like any interest in property, must involve public recognition of the interest. Using a Hegelian analysis, she suggests that property "involves the publicly recognizable identification of a specific object to a specific legal subject with some rights to control, and exclude others from, the object." *Id.* at 527 (citing, among other things, GEORG WILHELM FRIEDRICH, HEGEL, ELEMENTS OF A PHILOSOPHY OF RIGHT §§ 52-53, 58 (Allen W. Wood ed. & H.B. Nisbet trans., Cambridge University Press 1991) (1821)). Although she appears to support control as a method of perfection, it is not clear how that method would be "publicly recognizable," except among the parties to the contract.

has a purchase-money security interest in the item of equipment. If *V* perfects the security interest by filing an effective financing statement when the debtor receives the equipment, or within twenty days thereafter, *V* would have priority over any competing, prior security interest held by *SP*.[182] *V* may also believe that she has priority in the identifiable cash proceeds associated with the equipment.[183] Thus, if *D* sold the equipment or it was lost or destroyed, *V* would reasonably suppose that it has a proceeds security interest in whatever was received upon this disposition or loss, such as the purchase price *D* received or insurance payable with respect to the equipment.[184]

V might also reasonably expect she has priority in these proceeds. But *V* is likely to be wrong. UCC § 9-324(a) provides that the purchase-money priority in proceeds is subject to § 9-327, which sets forth the rules on the priority of control security interests. If the cash proceeds from the sale or loss of the equipment were deposited in a bank account maintained by *D*, there is no easy way *V* can be sure the bank that maintains *D*'s account, *B*, does not have a control-perfected security interest in the account. It will be possible to verify that *D* has not granted a security interest in the account to *B*, but it would take more than a typical lien search.

Not only will the lien itself be secret, but if and when *V* discovers it, she will also find that it has priority over her security interest, despite her purchase-money priority. This is because *B* would not only have the security interest in the account, but it would also have priority, even though the funds in the account may be proceeds of *V*'s equipment and even though the proceeds would otherwise be entitled to purchase-money priority in favor of *V*.[185] As the comment to UCC § 9-327 explains, "security interests perfected by control . . . take priority over those perfected otherwise, e.g., as identifiable cash proceeds . . . ."[186]

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182 UCC § 9-324(a) provides:

> [A] perfected purchase-money security interest in [equipment] has priority over a conflicting security interest in the same goods, and, except as provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20 days thereafter.

183 *Id*.

184 *Id*. § 9-102(a)(64) (defining proceeds).

185 *See id*. §§ 9-322(c), 9-327(1) ("A security interest held by a secured party having control of [a] deposit account under Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control.").

186 *Id*. § 9-327 cmt. 3.

How would *V* protect herself from the secret lien permitted by the control security interest in a deposit account? Presumably, determining the existence and nature of a control security interest would require consultation with the parties involved—the debtor, the secured party, and, in the case of trilateral control, the bank or intermediary that maintains the accounts. It is also to be assumed the banks and intermediaries would not collude with a debtor that fraudulently concealed the grant of a control security interest. There is, however, no obvious way to assure that a debtor has not entered into a control agreement. Under UCC § 9-342, a bank that has entered into a control security agreement is "not required to confirm the existence of the agreement to another person" unless the bank's customer (i.e., the debtor) so requests.[187] A similar rule obtains with respect to securities intermediaries or issuers who are parties to control agreements.[188] It is thus not clear how much comfort one can ever take in a statement that the debtor has not encumbered these assets. These assurances may well turn out to be false, and there would be limited recourse for the aggrieved party.[189]

V could also resort to other contractual protections. She could, for example, ask the debtor and the insurance company to have her named as loss payee with respect to the equipment. If so, and the casualty check was actually sent to *V*, her expectations would be protected.[190] Alternatively, *V* could enter into a subordination agreement with *B*, whereby *B* would agree that *V* would have priority in *D*'s account with respect to any casualty payments arising from damage to the collateral.[191] But there is no guarantee the other parties will enter into these agreements. In any event, it is difficult to imagine these contractual

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[187] *Id*. § 9-342.

[188] *Id*. § 8-106(g).

[189] Because the bank and broker have no duty to disclose anything, and no relationship with *V*, it is not clear how liability could be established. Presumably, a claim for breach of the duty of good faith could be made under UCC §§ 1-201(b)(20) and 9-625. It is not, however, clear that such a claim would have much likelihood of success. Even if established, it is not clear what the claim is worth. Section 9-625(b) only creates liability for violations of "this article," not the entire UCC. Even if liability were established, it would be limited to "actual" damages. If, however, the bank would have had priority anyway (i.e., because it had control), it is not clear what damages could be established. Absent outright fraud by a secured party, courts are reluctant to subordinate secured parties merely because recognizing priority would be "inequitable." *See, e.g.*, Peerless Packing Co. v. Malone & Hyde, Inc., 376 S.E.2d 161, 164 n.4 (W. Va. 1988) (absent "virtually fraudulent conduct," Article 9 priorities will be respected).

[190] Ironically, this would be true even if *V* did not otherwise have purchase-money priority, because the possessory security interest in a negotiable instrument will usually have priority over any competing interest in the same instrument. *Id.* §§ 9-330(d), 9-331(a).

[191] *Id*. § 9-339.

solutions are more efficient than a notice filing system that would readily alert *V* to the existence of *B*'s security interest and determine its priority ex ante. While control may bring important benefits to the banks and brokerages that sought this type of protection in revised Article 9, it is not clear that much consideration was given to costs associated with the secret liens that these transactions tolerate.

C. Asset Securitizations

New twists on old secured transactions are not the only potential source of secret liens in commercial finance law. A third source will involve recent statutory attempts to "facilitate" the development of asset securitization transactions, which potentially dispense with notice filing entirely. Under some of these statutes, if a contract transferring property uses requisite statutory language, the transfer will be effective even if in secret, and even if other law would require notice of it.

Although several states have enacted such laws, the most important is Delaware's Asset-Backed Securities Facilitation Act ("ABSFA").[192] ABSFA essentially contemplates a complete opt out of Article 9 and, if the statute means what it says, any other law that may conflict with the securitization contracts. "Asset securitizations" are generally defined as "the structured process whereby interests in loans and other receivables

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[192] DEL. CODE ANN. tit. 6 §§ 2701A-2703A (2004). Other states have facilitation statutes. *See* Alabama, ALA. CODE § 35-10A-2(a)(1) (2004); Louisiana, LA. REV. STAT. ANN. § 10:9-109(e) (West 2002); North Carolina, N.C. GEN. STAT. § 25-9A-102 (2002); Ohio, OHIO REV. CODE ANN. § 1109.75 (Anderson 2002); Texas, TX. BUS. & COM. § 9.109(e) (Vernon 2002). The statutes in Alabama, North Carolina, and Ohio are substantially similar to ABSFA, with all but Ohio's statute entitled "Asset-Backed Securities Facilitation Act." *See* ALA. CODE § 35-10A-2(a)(1); N.C. GEN. STAT. § 25-9A-102; OHIO REV. CODE ANN. § 1109.75. Texas and Louisiana, by contrast, simply added a new subsection to Article 9 of the revised UCC that left it up to the parties involved in securitization transactions to classify the nature of transfers. *See* LA. REV. STAT. ANN. § 10:9-109(e); TX. BUS. & COM. § 9.109(e).

Texas's Article 9, for example, provides:

> The application of this Chapter to the sale of accounts, chattel paper, payment intangibles, or promissory notes is not to recharacterize that sale as a transaction to secure indebtedness but to protect purchasers of those assets by providing a notice filing system. For all purposes, in the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of such assets shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets regardless of whether the secured party has any recourse against the debtor, whether the debtor is entitled to any surplus, or any other term of the parties' agreement.

TX. BUS. & COM. § 9.109(e).

are packaged, underwritten, and sold in the form of “asset backed” securities.”[193]

A securitization typically involves at least two parties: the “originator” and the special purpose entity (“SPE”). The originator is the original owner and creator of the financial assets, such as accounts receivable, lease payments, credit card receivables, or mortgage receivables, that are the subject of the securitization transaction. The originator might, for example, be an equipment leasing company, which is owed lease payments from its lessees. The lessee’s payment obligations are an asset of the originator. The SPE is the initial purchaser of these eligible assets.[194]

Like a secured transaction, the heart of a securitization is a property transfer. The goal of a securitization is a “true sale” of financial assets from the originator to the SPE.[195] If the transfer of these assets is a true sale, then the assets should be insulated from the originator’s economic troubles.[196] If the transfer is not a true sale—but is, for example, a transfer for security (i.e., a disguised financing)—the originator’s bankruptcy estate would retain an interest in the assets. The assets would then be subject to the many provisions of the Bankruptcy Code that constrain third parties from acting with respect to property of the debtor’s estate.[197]

An effective securitization should free the securitization provider—or, more particularly, those holding the securities issued in the transaction—from Bankruptcy Code provisions that: (i) stay acts to obtain possession of, or collect from, property of the debtor’s estate,[198] (ii) permit the debtor to use cash collateral,[199] and (iii) cram-down secured

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193 COMPTROLLER OF THE CURRENCY: ADMINISTRATOR OF NATIONAL BANKS, ASSET SECURITIZATION: COMPTROLLER’S HANDBOOK (1997), *available at* http://www.occ.treas.gov/handbook/assetsec.pdf. *See also* TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1995); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002) [hereinafter SCHWARCZ, STRUCTURED FINANCE]; SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1999); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STANFORD J.L. BUS. & FIN. 133 (1994).

194 Securitizations may also involve a third entity that purchases the eligible assets from the SPE and issues the securities backed by the income stream they produce.

195 Thomas J. Gordon, Comment, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. CHI. L. REV. 1317, 1318 (2000).

196 *Id*. (securitization eliminates risk of regular unsecured and secured arrangements).

197 *See, e.g.*, 11 U.S.C. § 362 (2000).

198 *Id*. § 362(a)(3), (6).

199 *Id*. § 363(c)(2).

claims in a plan of reorganization.[200] Indeed, some commentators claim the "efficiency" of securitization derives, in part, from separating the debtor and the debtor's other creditors from these assets.[201] Although estimates of the value of the securitization market vary, it generally involves more than two trillion dollars at any time.[202]

If securitization transactions always involved arms length, fair value sales of payment rights (e.g., receivables), they would likely present few problems.[203] However, securitization transactions are often structured in such a way that the originator retains the risk that there will be a default or other problem with the underlying assets.[204] For example, the originator may be required to repurchase these assets from the SPE in the event the underlying account obligor defaults. As and to the extent there is recourse to the originator, the transaction looks less like a "true sale" and more like a secured financing.[205]

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[200] *Id*. § 1129(b)(2).

[201] *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); Minh Van Ngo, *Agency Costs and the Demand and Supply of Secured Debt and Asset Securitization*, 19 YALE J. ON REG. 413, 458 (2002); *see also* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996) [hereinafter LoPucki, *Death of Liability*] (discussing benefits of asset securitization where company keeps valuable assets separate from entities at risk).

[202] One estimate exceeds five trillion dollars. *See* Thomas A. Humphries, *The Way (Securitization) Things Ought to Be*, 638 PLI 641, 641 n.2 (2004) (citing Discussion Paper, International Swaps and Derivatives Association & The Bond Market Association, Special Purpose Entities (SPEs) and the Securitization Market 1 (Jan. 31, 2002), *available at* http://www.isda.org/speeches/pdf/SPEDiscussionPaper1-31-02.pdf.). A recent symposium issue of the *Cardozo Law Review* suggests that securitization may be overtaking and displacing secured lending as the dominant form of commercial finance. Symposium, *Threats to Secured Lending and Asset Securitization*, 25 CARDOZO L. REV. 1539 (2004).

[203] If, in other words, they were not "judgment proofing" devices. *See* LoPucki, *Death of Liability*, *supra* note 201, at 14-38.

The structured transactions used by Enron are occasionally offered as proof of the potential abuse of securitizations. *See, e.g.*, Robert B. Thompson, *Corporate Governance After* Enron, 40 HOUS. L. REV. 99, 114-15 (2003) (Enron's balance sheet deceptions were a "securitization policy."). Professors Plank and Schwarcz have each argued the Enron transactions were sui generis, "patently improper transactions." Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1657 (2004); *see* Schwarcz, Enron, *supra* note 16 (distinguishing Enron transactions from securitization transactions). The difficult part, however, is that neither Plank nor Schwarcz have offered a solution to the true sale problem that does not also create a secret lien problem. Moreover, as discussed *infra*, notes 266-92 and accompanying text, saying that there are differences between "good" and "bad" transactions is no justification for legislation that would insulate both from judicial scrutiny, which is the literal effect of ABSFA.

[204] Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1770-71 (2004) (discussing transaction structures that provide recourse to originators).

[205] SCHWARCZ, STRUCTURED FINANCE, *supra* note 193, at 621-27; Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 161 (1996); Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287,

Although asset securitization is a comparatively recent development in commercial finance, the true sale problem has existed for many years.[206] On one hand, our law has long permitted a buyer to "put" defective assets back to a seller (e.g., through a breach of warranty theory) without calling into question the sale character of the transaction.[207] On the other hand, transactions in which the "seller" guarantees payment,[208] or a particular return on investment,[209] or the "buyer" has full recourse to the seller are generally viewed as loans and not sales.[210] At the margins, it is—and has been for many years—difficult to distinguish sales from secured loans.[211]

307-08 (1991) [hereinafter Plank, *True Sale of Loans*] (arguing payment of the full value, not the existence of recourse, should constitute the border between sales of and security interests in accounts and chattel paper); Peter L. Mancini, Note, *Bankruptcy and the UCC as Applied to Securitization: Characterizing a Mortgage Loan Transfer as a Sale or a Secured Loan*, 73 B.U. L. REV. 873, 876-77 (1993).

[206] *See* Pantaleo et al., *supra* note 205, at 164 ("Recharacterization [(true sale)] cases are centuries old. They illustrate that the law may not treat a transaction as a sale just because the buyer and seller labeled it a sale.") (footnote omitted).

[207] *In re* Grand Union Co., 219 F. 353, 360 (2d Cir. 1914) (Seller of accounts agreed that if the accounts were of poor quality, it would repurchase them or pay buyer so as to guarantee a certain rate of return for the buyer.); Comm. on Bankr. & Corp. Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 543-44 (1995) (describing forms of recourse that may be permissible in structured finance transactions).

[208] *See* Ratto v. Sims (*In re* Lendvest Mortgage, Inc.), 119 B.R. 199, 200 (B.A.P. 9th Cir. 1990) ("Where the risk of loss is shifted from the investor to the debtor through a contractual guarantee of repayment by the debtor, the transaction is a loan and not a sale.").

[209] *See* Ables v. Major Funding Corp. (*In re* Major Funding Corp.), 82 B.R. 443, 445 (Bankr. S.D. Tex. 1987); Castle Rock Indus. Bank v. S.O.A.W. Enters., Inc. (*In re* S.O.A.W. Enters., Inc.), 32 B.R. 279, 281-82 (Bankr. W.D. Tex. 1983) (Seller originated mortgages, sold certain interests in them to buyer, guaranteed the buyer's recovery on the mortgages and the buyer's rate of return on its investment, indicating the transaction was a loan for security and not a sale.); *see also* Fireman's Fund Ins. Cos. v. Grover (*In re* Woodson Co.), 813 F.2d 266, 271 (9th Cir. 1987) (holding there was no true sale where investors with the debtor, who were alleged to own mortgages originated by the debtor, "were paid interest monthly regardless of whether the original borrower paid [the debtor]. In the event of default, [the debtor] paid the investor the interest and the principal balance owed on the investor's [original deposit]."); Merchant's Transfer & Storage Co. v. Rafferty (*In re* Gotham Can Co.), 48 F.2d 540, 541-42 (2d Cir. 1931) ("The obligation of [the seller] to repay [the buyer] all advances [on accounts allegedly sold] in full and to pay certain percentages for the use of the money, shows that the transactions were essentially collateral loans, and not sales . . . ."); Pantaleo et al., *supra* note 205.

[210] Burford-Toothaker Tractor Co. v. United States, 262 F.2d 891, 894-96 (5th Cir. 1959) (Transferor assigned customers' installment contracts to bank, but assignment was with full recourse, and bank required periodic payments to be made to the bank by the transferor, whether or not the customers had paid on the installment contracts. The court held on these facts that no sale of the installment contracts occurred.).

[211] The true sale question was also central to the dispute in *Benedict v. Ratner*, 268 U.S. 353 (1925). There, Justice Brandeis, writing for a unanimous court, held that a sale of future accounts receivable was really a disguised financing, and therefore a fraudulent conveyance void against the

The recent history of true sale is dotted with cases in which courts were reluctant to recognize the putative sale of payment obligations. In 1993, the United States Court of Appeals for the Tenth Circuit, in *Octagon Gas Systems v. Rimmer (In re Meridian Reserve, Inc.)*, held financial assets sold by the debtor prior to its bankruptcy should, in fact, be included in the debtor's bankruptcy estate.[212] More recently, and more controversially, the court in *LTV Steel* extended the reasoning of *Octagon* to conclude that the bankruptcy estate of the originator retained an equitable interest in financial assets and inventory "sold" in a securitization.[213]

Parties to securitization transactions have attempted to address the true sale problem with fairly elaborate structures and "true sale" opinion letters from lawyers, which ostensibly assuage the bond market and those who invest in securitization transactions. Such structures and opinion letters are not, however, costless. Viewing these costs as excessive, the securitization industry has sought to establish legislative safe harbors.[214] The most prominent effort to obtain a statutory safe harbor involved § 912 of the Bankruptcy Reform Act of 2001.[215] This provision would have amended the Bankruptcy Code to provide that assets transferred in a qualifying transaction would be excluded from the debtor's estate. In light of the alleged misuse of SPEs in the *Enron* case, § 912 was challenged and eventually pulled from the Bankruptcy Reform Act.[216]

assignor's bankruptcy trustee. *Id.* at 361-63. The purchaser's failure to exercise dominion and control over the accounts was a fraud on the debtor's creditors. *Id.* at 363 (holding the assignment was fraudulent "because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien."). For thoughtful rehabilitations of *Benedict*, see Edward J. Janger, *Brandeis, Progressivism, and Commercial Law: Rethinking* Benedict v. Ratner, 37 BRANDEIS L.J. 63, 74 (1998) (arguing *Benedict* reflected Brandeis' "'progressive' passion for financial accountability"); Schroeder, *Surrealism*, *supra* note 41, at 527-28 (arguing the totally subjective nature of the assignments prevent creation of a complete property interest in the accounts).

212 995 F.2d 948, 957 n.9 (10th Cir. 1993) (rejecting view that sale of asset, if perfected, removes it from transferor's bankruptcy estate).

213 *In re* LTV Steel Co., 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001) ("To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. . . . [T]here seems to be an element of sophistry to suggest that Debtor does not retain at least an *equitable* interest" in the cash collateral.).

214 *See, e.g.*, Letter from John R. Vogt, Bond Market Association Executive Vice President, to Senator Patrick Leahy and Congressman F. James Sensenbrenner (Jan. 30, 2002), *at* http://199.106.213.75/regulatory/abs013002.pdf, at 2-3.

215 S. 220, 107th Cong. § 912 (2001); H.R. 333, 107th Cong. § 912 (2001).

216 *See* Lipson, *Enron*, *supra* note 16, at 3.

Nevertheless, several states have enacted non-uniform statutes which would reach the same result, although they take a more circuitous and troubling route.[217] Delaware's ABSFA is perhaps the most aggressive example of this. It declares that a true sale will be whatever the parties to the securitization transaction say it is.[218] ABSFA provides, "[n]otwithstanding any other provision of law," any property purported in the transaction documents to be transferred in a securitization transaction "shall be deemed to no longer be the property, assets or rights of the transferor."[219] The transfer of property by the originator shall, under ABSFA, be effective notwithstanding bankruptcy, insolvency, or any other rights third parties might assert in the transferred assets. "A transferor in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor or the transferor's property, a bankruptcy trustee . . . shall have no rights, legal or equitable, whatsoever to reacquire, reclaim . . . or recharacterize as property of the transferor any property" transferred in the securitization.[220] For emphasis, ABSFA further provides that if the transferor enters bankruptcy, the transferor's "property, assets and rights shall not be deemed to be part of the transferor's property, assets, rights or estate."[221]

For purposes of the problem of secret liens, the critical language in ABSFA is "notwithstanding any other provision of law." This presumably means the rules in Article 9 and any other state commercial finance statutes do not apply if property is conveyed in a "securitization," a term pointedly not defined by the statute.[222] Thus, ABSFA creates an exception to the Article 9 requirement that parties to a securitized transaction give notice of the transaction by filing a UCC-1 financing statement. ABSFA requires no notice to render a sale effective, and purports to displace any conflicting law.

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[217] *See supra* note 192.

[218] DEL. CODE ANN. tit. 6, § 2703A(a)(1) (2004).

[219] *Id.*

[220] *Id.* § 2703A(a)(2).

[221] *Id.* § 2703A(a)(3). In 2002, Delaware apparently sought to bolster the effectiveness of ABSFA by amending its former Business Trust Act to rename it the "Statutory Trust Act" "for the purpose of avoiding any implication that a trust formed [thereunder] constitutes a 'business trust' within the meaning of the Bankruptcy Code." Stephen H. Case, *I Thought I Put That Where You Couldn't Reach It: Bankruptcy-Remote Entities, Special Purpose Vehicles and Other Securitization Issues*, 853 PLI/Comm. 53, 79 (2003) (citing Matthew J. O'Toole, *Analysis of 2002 Amendments to the Delaware Statutory Trust Act*, at [unnumbered page] DEL. LAWS AFFECTING BUSINESS ENTITIES (2002)); *see* DEL. CODE ANN. tit. 12, § 3801.

[222] *See* DEL. CODE ANN. tit. 6 §§ 2701A-2703A.

A quick response may be: So what? As noted above, Article 9 contemplates a growing number of transactions in which property transfers can be effective without notice filing.[223] Security interests in data and intellectual property will often be undiscoverable from the public record.[224] Similarly, security interests in a wide variety of assets—deposit accounts and investment property—can be perfected by control.[225] The problem is that ABSFA applies not only to financial collateral, but also to "[a]ny property, assets or rights purported to be transferred, in whole or in part."[226] Had ABSFA applied to the securitizations in *LTV*, for example, it would have validated even the controversial transactions involving inventory, although such assets are not typically securitized.[227] A similar result might obtain in *Enron*.[228] Indeed, read literally, ABSFA should authorize intentional fraudulent transfers because it trumps any competing state law.

ABSFA's failure to define a qualifying transaction is equally troubling. ABSFA guarantees true sale treatment "to the extent set forth in the transaction documents."[229] Thus, a transfer of property can be effected solely by contract, whether or not the transaction bears any resemblance to the common securitization. Any secret lien would appear to be effective under Delaware law so long as it is "set forth in the transaction documents."[230]

ABSFA appears to envision a world in which any property transfer is enforceable, even if secret, so long as the transaction documents contain the magic statutory incantation. Notice filing under ABSFA appears to be entirely optional. In order to discover that a debtor has already sold its assets in a securitization, a potential purchaser or secured party could never rely on a clean lien search. The possibility that a debtor may, in secret, have engaged in a qualifying transaction under ABSFA means that there is simply no way other than contract and diligence to know that one is in fact acquiring clean title to, or priority in, the debtor's property. ABSFA contains no exception for fraud or mistake.[231]

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223 *Supra* Part II.

224 *See supra* Part II.A.

225 *See* discussion *supra* Part II.B.

226 DEL. CODE ANN. tit. 6, § 2703A(a)(1).

227 *Compare* Plank, *True Sale of Loans*, *supra* note 205.

228 *See* Lipson, *Enron*, *supra* note 16.

229 DEL. CODE ANN. tit. 6 § 2703A(a).

230 *Id*.

231 There are ways that a bankruptcy trustee, disappointed purchaser, or secured party could try to get around ABSFA. They could argue that based on choice-of-law principles, Delaware law did

III. How Did We Get Here? The Political Economy of Notice Filing in Commercial Finance Law

Why are we increasingly tolerant of secret liens? In simple terms, it is because we have become convinced that notice filing is economically unsound. The benefits of notice filing, we are told, do not justify the costs. This Part considers these arguments.

A. *The Economic Analysis of Commercial Finance Law*

A certain kind of economic analysis of law—typically associated with the University of Chicago and Ronald Coase—has altered the way we approach most categories of private law, from antitrust to bankruptcy.[232] Like the economic analysis of law in general, the question here is one of institutional choices and the costs and benefits those choices imply. Is the "state," in the form of mandatory notice filing rules, or the "market," in the form of "secret" contracts, likely to produce greater benefit to society?[233] Commercial finance law—and in particular, the law of secured lending—has not been immune from this inquiry. Its specific roots are located in a 1979 *Yale Law Journal* article by Professors Jackson and Kronman, which asked a very basic question: Is secured lending efficient?[234]

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not apply; that the transaction was not a "securitization" (however defined); or, in the case of bankruptcy, that federal law preempts ABSFA. These are not necessarily trivial arguments, but they have little to do with assuring that information about nonpossessory property interests is reasonably easy to discover.

[232] *See* Richard A. Epstein, *Law and Economics: Its Glorious Past and Cloudy Future*, 64 U. CHI. L. REV. 1167, 1167 (1997) ("The magnitude of the intellectual revolution [of economic analysis] is hard to recount today because virtually everyone who works in common law subjects is familiar with the now routine exercise of showing why it is, or has to be, the case that this or that common law rule is, or is not, efficient.").

Coase's landmark contribution to legal thought appears in R.H. Coase, *The Problem of Social Cost*, 3 J.L. ECON 1 (1960), *reprinted in* R.H. COASE, THE FIRM, THE MARKET AND THE LAW 95 (U. of Chi. Press 1988), an article which has become the runaway citation champion among published law review articles. *See* Fred R. Shapiro, *The Most-Cited Law Review Articles Revisited*, 71 CHI.-KENT L. REV. 751, 759 (1996) (indicating Coase's article was cited almost twice as often as the next most cited law related article). Coase had earlier suggested the contours of the problem of social cost in R.H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1, 33 (1959)).

[233] *See generally* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS AND PUBLIC POLICY (1994).

[234] Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

This seductive question emanates from the Modigliani-Miller invariance theory.[235] Economists Modigliani and Miller famously suggested that in a perfect capital market, the value of a firm could not be traced to the organization of its capital structure.[236] Thus, if a debtor, *D*, granted a security interest in its assets in order to obtain financing from a secured party, *SP*, other firm investors—in particular, unsecured creditors—should charge more, reflecting their increased risks arising from *SP's* security interest. Whatever *D* might save in reduced interest costs charged by *SP* should be at least offset by an increased rate of interest charged by unsecured creditors. A firm's value—and in particular, the cost of capital to a firm—would not vary by virtue of the use of secured financing.

The persistence of secured lending puzzled economically-oriented writers.[237] Secured transactions were challenging not only on a Paretian model, but also in larger societal terms.[238] It is expensive to engage in a secured transaction, and doing so may also create greater social costs through negative externalities. Many creditors—unsophisticated trade creditors, tort creditors, terminated employees, taxing authorities, and others—do not in fact charge higher rates of interest to offset the risk of

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[235] Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

[236] *Id.*; *see* Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. ECON. PERSPECTIVES 99 (1988). *Cf.* David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2299 (1994) [hereinafter Carlson, *Efficiency*] (Economic analysis of secured lending "emanates from a peculiar misunderstanding of the famous Modigliani-Miller model . . . ."). According to Carlson, "[t]he Modigliani-Miller model died in 1976, when Michael Jensen and William Meckling pointed out that Modigliani and Miller assumed that corporate structure never changes debtor behavior." *Id.* (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 332-33 (1976)). Jensen and Meckling identified the problem of agency cost—the cost imposed by the risk that an agent will act, wittingly or not, to the disadvantage of its principal. Jensen & Meckling, *supra*.

While the Modigliani-Miller theory may have many flaws, it remains an important tool in conceptualizing the microeconomics of firm financing. Professor Schwarcz, for example, purports to have "solved" the puzzle of secured lending, given certain assumptions, using Modigliani and Miller. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 429 (1997) [hereinafter Schwarcz, *Easy Case*].

[237] *See, e.g.*, Jackson & Kronman, *supra* note 234.

[238] "Paretian" refers to the concept of "pareto superior" transactions—transactions where "at least one person in the world [is] better off and no one worse off." RICHARD A. POSNER, THE ECONOMIC ANALYSIS OF LAW 12 (Little, Brown & Co. 3d ed. 1986). The Pareto test of efficiency is sometimes contrasted with the "Kaldor-Hicks" model, which provides that "a move is efficient whenever the winners win more than the losers lose, in the sense that, if the winners compensated the losers to their satisfaction, the winners would still be better off than they were before the change." Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211, 1222 (1991).

extending credit to a debtor whose assets are encumbered; they cannot "adjust" to the increased risk posed by the debtor's grant of a security interest.[239] Thus, while a secured creditor with full contractual priority has access to all of a debtor's property, vulnerable unsecured creditors do not. This would create perverse managerial incentives for *D* to disregard risks thus externalized.[240] The debtor that gave full priority in its assets to a particular secured creditor would have externalized all losses onto those in the worst position to protect themselves.[241] Because the transaction costs associated with secured lending were presumed greater than the transaction costs associated with other methods of financing, many academics followed the lead of Jackson and Kronman in asking why rational market actors would engage in such transactions.[242]

Asking and answering the questions posed by the Modigliani-Miller puzzle, as writ small in commercial finance law, became an enormously attractive enterprise for legal academics.[243] Because it has been so

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[239] The term "nonadjusting creditors" is generally associated with Bebchuk and Fried, who use it in Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864 (1996). Bebchuk and Fried take the term one step further and apply it to all creditors for whom adjustment may either be costly or implausible, such as small dollar trade creditors or creditors who extended unsecured credit before the debtor granted the security interest. *Id.* at 864-66.

[240] *Id.* at 934 (arguing the rule of full priority "causes excessive use of security interests, reduces the incentive of firms to take adequate precautions and choose appropriate investments, and distorts the monitoring arrangements chosen by firms and their creditors").

[241] As Bebchuk and Fried explained:

> The fact that security interests may be used to transfer value from nonadjusting creditors under a full-priority rule means that security interests may be used even when they give rise to inefficiencies. As our analysis will demonstrate, the ability to use security interests to divert value from nonadjusting creditors tends to distort the borrower's choice of contractual arrangements with its creditors, giving rise to certain efficiency costs.

Id. at 865.

A number of responses have developed reasonably plausible claims that secured lending, under certain circumstances, can be efficient. *See, e.g.*, Carlson, *Efficiency*, *supra* note 236, at 2209-12; Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Schwarcz, *Easy Case*, *supra* note 236; Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989).

[242] Contributions to this body of literature are collected in Lipson, *Remote Control*, *supra* note 101, at 1403 n.403.

[243] *See, e.g.*, Jackson & Kronman, *supra* note 234, at 1154 n.46; Shupack, *supra* note 241

A curious feature of the economic analysis of commercial finance law—the "puzzle literature"—is its obsession with Modigliani and Miller, to the apparent exclusion of other economic concerns. *See* William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 124 n.140 ("Oddly, the irrelevance hypothesis has had a stranglehold on commercial-law theory."). There is, as David Gray Carlson and others have observed, more to the economic story than simply a price-theory explanation of firm capitalization. *See* Carlson, *Efficiency*, *supra* note 236, at 2198, 2211 (summarizing critiques); *see also* G. Ray difficult to develop a satisfactory explanation for the persistence of secured credit on traditional price theory, a number of economically oriented writers have suggested the real virtue of secured credit lies in the informational value of these, as distinct from other, financing transactions. Varieties of this theory appear in the work of, among others, Jackson and Kronman,[244] Frank Buckley,[245] Alan Schwartz,[246] Barry Adler,[247] Saul Levmore,[248] and George Triantis.[249] All have suggested that secured credit plays an important part in solving information asymmetries among a debtor and its various constituents and, implicitly, that information may play some role in assessing the efficiency of secured lending.[250] As Professor Triantis has explained, "[t]here is little doubt that when a firm secures a larger portion of its debt than similarly situated firms it communicates information of some sort to the market."[251]

Ironically, while economic analysis has been quick to recognize the link between property, information, and commercial finance law, it has been indifferent at best, and occasionally hostile, to established methods (i.e., financing statements) of signaling the existence of nonpossessory property interests, such as security interests. It is this indifference which, at a theoretical level, may in part explain our increasing tolerance for secret liens.

Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 12 (2001) ("[A]lthough the economic analysis is useful in analyzing questions of allocative efficiency, it does not provide much insight into questions of distributive efficiency.").

244 Jackson & Kronman, *supra* note 234.

245 Frank H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986).

246 *See* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 15 (1981) [hereinafter Schwartz, *Review*] ("A firm willing to encumber its assets is, thus, 'signaling' that, in its view, its prospects justify" the costs of secured credit); *see also* Alan Schwartz, *A Theory of Loan Priorities*, 18 J LEGAL STUD. 209 (1989 [hereinafter Schwartz, *Theory*]; Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396 (1997).

247 Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993).

248 Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982).

249 George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992).

250 Information asymmetries arise whenever one party to a transaction possesses superior information. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 595 n.134 (1984) ("The difficulty of assuring oneself of the value of purchased information has been recognized for some time."); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 698 (1986).

251 Triantis, *supra* note 249, at 255.

1. Signaling

One informational function a secured transaction might perform can be characterized as "signaling." Alan Schwartz initially suggested—but later rejected—the idea that a security interest would be a kind of "signal" because it would "restrict future borrowing opportunities, give secured creditors greater leverage over firm behavior, and make it more difficult for a firm to reschedule debts in the event of hard times."[252] A security interest might thus be an efficient signal to the world that a firm believes its prospects justify these costs.[253] "The apparent property of a secured debt to communicate accurately to creditors a firm's true estimate of its expected earnings indicates that the existence of secured debt may be explained as a signaling phenomenon."[254] Secured lending may thus be "a way" for debtors to "sort[] themselves out by risk class."[255]

Schwartz nevertheless had doubts about the signaling explanation.[256] First, he correctly observed that the strength of the signaling explanation depended on the knowledge that other creditors have of the risk preferences of the owners and managers of the debtor.[257] But there is no particular reason to imagine that creditors will know this, or that such information is necessarily cheap and easy to obtain.[258] Moreover, the signal may itself be ambiguous as to the quality of firm projects.[259] If so, these informational ambiguities would infect the equilibrium obtained from viewing security interests as signals.[260] The signal-to-noise ratio

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[252] Schwartz, *Review*, *supra* note 246, at 15. Professor Buckley developed a related view that secured lending performs a "screening" function. *See* Buckley, *supra* note 245, at 1421-1426. Buckley observed that if a debtor had only unsecured creditors, lenders would have to examine a debtor carefully to determine its liquidation value in a bankruptcy. *Id.* at 1424. This would be costly because, among other reasons, they would have to know of one another's claims. Inserting a secured creditor into the mix, however, would reduce the screening costs of unsecured creditors because they would assume that they would recover nothing if the debtor liquidated. *Id*. (Where unsecured creditors assume that they recover nothing in bankruptcy, they "need not estimate how many other claims will be made on bankruptcy.").

[253] Schwartz, *Review*, *supra* note 246.

[254] *Id*.

[255] *Id*. at 17. Judge Posner makes a similar claim about the informational virtues of secured lending. "Secured credit reduces the information costs of secured creditors while not raising, and possibly even reducing, the information costs of the unsecured creditors." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 436 (Aspen Law & Business 5th ed. 1998).

[256] *See* Schwartz, *Review*, *supra* note 246, at 18.

[257] *Id*. at 17-18.

[258] *Id*.

[259] *Id*. at 18.

[260] *Id*.

may not, in general, be great enough to justify the externalities created by secured lending.[261]

2. Contractual Priority

For purposes of this Article, Schwartz's principal contribution on the information function of secured lending appeared in a 1989 article in which he argued that notice filing had little value as a means of conveying information about property interests in commercial finance transactions, at least so far as other creditors might be concerned.[262] This followed from his view of the capital structure that rational parties would choose ex ante.[263] Schwartz surmised that such parties would, absent legal intervention, choose highly rigid capital structures, which would always give the first lender priority in the debtor's assets, subject to a limited purchase-money carve-out, whether or not the parties characterized the loan as being secured.[264]

Schwartz began his analysis by surveying form books and practitioner guides, which indicated lenders often asked borrowers to agree to restrictive covenants that forbade later borrowing, subject to certain agreed-to exceptions, such as ordinary course trade debt.[265] From the existence of these covenants, Schwartz concluded the "optimal contract" would give first financers priority over all (or most) later non-ordinary course lenders.[266] That is, the law should recognize what he called a "true first-in-time (FT)" rule, "that confers senior rank on the initial financer who just enters into a loan contract."[267]

The problem with such a system, Schwartz observed, was informational: How would later creditors learn that the earlier creditor had priority?[268] How, in other words, would later creditors verify and measure other interests affecting the debtor's property?[269] Schwartz

[261] *Id.* ("If a security-interest signal . . . actually tells creditors little about the riskiness of firm projects, too much signaling could occur in equilibrium; the total costs that firms incur in sending signals will exceed the total social gain generated by more appropriate credit extensions.").

[262] Schwartz, *Theory*, *supra* note 246.

[263] *Id.* at 222.

[264] *See id.* at 213 ("The UCC should give initial financers first priority, whether or not they are secured, except for a reduced purchase-money priority.").

[265] *Id.* at 216-18.

[266] *Id.* at 218-19.

[267] *Id.* at 219.

[268] *Id.*

[269] "The question is whether to adopt a true FT rule and thereby permit parties to create secret liens or to incur the expense of a new filing regime." *Id.* (footnote omitted).

argued that in a true FT system, later creditors would learn of prior interests because debtors would want to inform them.[270] Schwartz reasoned that "sensibly conservative" lenders would assume that all or most debtors are "bad" and should therefore pay a high rate of interest.[271] Truly "good" debtors—those that should receive a low rate of interest—would therefore have an incentive to distinguish themselves.[272] "Good debtors," Schwartz suggested, "could avoid paying the high interest rates that uninformed lenders would charge by informing the lenders that they had little or no prior debt."[273] The "key question," Schwartz observed, was whether borrowers could "make credible communications of their debt status at acceptable cost."[274] He also observed that firms which borrow take the interest cost deduction.[275] A simple review of any given borrower's income tax return would therefore reveal the existence of significant prior debt.[276] Moreover, to the extent a debtor was required to report under federal securities laws, material indebtedness would likely be reported.[277] In any case, Schwartz argued:

> [B]ecause private disclosure seems both cheap and common, there is no good case for retaining current law on the sole ground that implementing a new priority scheme would prohibitively increase the necessary costs of notifying creditors of the existence of prior claims in a borrower's property. . . . The expense to the parties of observing the borrower's books, which is the primary marginal cost of a true FT rule, seems cheaper than the costs of a new public system.[278]

It is not clear how a notice filing regime would work in a system with a true FT rule. On the one hand, Schwartz seems to believe that a true FT rule could peacefully coexist with the extant notice filing regimes.[279] While notice filing may no longer be necessary vis-à-vis other

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270 *Id*.

271 *Id*. at 220.

272 *Id*.

273 *Id*.

274 *Id*. He was thus not concerned with demarcating priority clearly, as might happen with a notice filing system. "A true FT system probably would date priority from when the initial loan contract was legally effective. This almost always will be when it is signed." *Id*. at 222 n.24.

275 *Id*. at 220.

276 *Id*. at 220-21.

277 *Id*. at 221.

278 *Id*. at 222.

279 *Id*. at 223 ("The conclusion that a true FT rule is preferable to creating a new filing system does not imply that the existing filing system should be abolished.").

creditors, it would, in his view, continue to perform an important function as to buyers of a debtor's assets.[280] Indeed, it could even persist as to creditors, although it would not likely have much value.[281] On the other hand, it is not clear why creditors would bother to take security in a world in which it was always possible, and perhaps probable, that the debtor had a true FT creditor who would trump the later secured party.[282] In a world with a true FT rule, secured creditors would be few and far between.

Although Schwartz does not speak of the true FT system as if it would create encumbrances, he recognized its potential to create a secret lien problem.[283] Schwartz dismissed the problem, however, because "good debtors conveniently can separate themselves from bad debtors."[284] First, he argued, "borrowers know that to commit fraud would require them to sustain credible lies against skilled inquirers for a considerable period of time."[285] Second, he reasoned that borrowers want to preserve good will; incorrect disclosures about the existence or not of a true FT lender would harm the debtor's reputation.[286] Third, if the loan market were competitive, a separating equilibrium would develop in which the pooling rate of interest would tend to price in the assumption that borrowers had prior true FT debt.[287] Truly debt-free borrowers would have an incentive to disclose credibly their debt-free status or risk "punishment" in the form of the higher pooling rate.[288] Unless the cost of disclosure were enormous, he reasoned, it would be in the interest of

[280] *Id*. ("Consequently, the FT rule should apply only to creditor disputes, and the filing system should be retained to regulate conflicts between financers and later buyers."). This creates an interesting problem: How should it work in the presence of securitizations, which purport to sell assets?

[281] *Id*. at 223-24 ("A . . . reason to retain the filing system is that filing has been considered a necessary condition to the perfection of security interests. There is no good reason to ban security interests . . . .").

[282] Such a system might present practical problems. If a debtor had a true FT creditor, the creditor's effective interest in the debtor's property would correspond to the amount of credit extended, which would presumably be an amount that could vary over time as the creditor made subsequent advances, as interest and other costs accrued, and as the debtor made principal and interest payments. If a later creditor sought to take a security interest in an item of equipment it was selling to the debtor, it could never know for certain that the true FT would not make a subsequent advance that effectively primed the secured party.

[283] *See* Schwartz, *Theory, supra* note 246, at 223-24.

[284] *Id*.

[285] *Id*. at 224.

[286] *Id*.

[287] *Id*. at 225.

[288] *Id*. at 224.

borrowers to convey accurately the truth about the interests others had in their property.[289]

Of the prominent economic writers, Schwartz's analysis has the virtue of being the most forthright in its indifference to notice filing and the problem of secret liens. The problem disappears, in Schwartz's world, because markets and contracts will, over time, produce more efficient results than mandatory regimes like Article 9.[290] Schwartz's position suffers, however, from the optimism that tends to afflict much hard economic analysis of commercial finance law. There is simply no reason to believe debtors and creditors would behave in the ways that he predicted in a true FT system. If nothing else, recent corporate scandals suggest that very sophisticated people can make serious mistakes about the real value of complex firms. People can—and apparently will—use this complexity to conceal true firm value. It has not been demonstrated that a true FT system would address and modify such behavior.

Economic analysis of this sort is no longer cutting edge[291] and has long been the subject of considerable skepticism. Part of the problem appears to be that this analysis privileges contract in a way that many find questionable on normative or institutional grounds.[292] Even on its own terms, much of the "low hanging fruit" promised by the economic study of law has been captured and devoured, in some cases digested and in other cases regurgitated. Still, it is highly likely this type of economic thought has influenced the legislative trend away from notice filing. An overarching goal of revising Article 9, for example, was to promote economic efficiency by making secured transactions easier, more certain, and theoretically cheaper.[293] The Reporters for the committee that drafted Revised Article 9 explained it thus:

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[289] *Id*. at 224-25.

[290] *Id*.

[291] *See* Epstein, *supra* note 232.

[292] *See, e.g.*, Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503; Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

[293] Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of U.C.C. Article 9?: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357 (1999); *see* Harry C. Sigman, *Twenty Questions About Filing Under Revised Article 9: The Rules of the Game Under New Part 5*, 74 CHI.-KENT. L. REV. 861 (1999) (Revised Article 9's provisions are intended to "make filing office practices more efficient, transparent, and uniform."); *see also* Patrick A. Murphy, *Revised Article 9 in Bankruptcy Cases*, *in* PRACTISING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES, PLI ORDER NUMBER A0-00HP (Sept. 2003) ("The purpose of Revised Article 9 is to simplify commercial transactions and, in the process, to make them more efficient and less likely to be upset in bankruptcy cases.").

> [M]any . . . provisions of Revised Article 9 reflect the Drafting Committee's effort to achieve more than merely "better," more "efficient," "equitable," or "reasonable" rules to govern secured transactions. An overarching goal of the revisions was to provide in the transactional context enhanced certainty and predictability from the inception of transactions. This certainty can facilitate transactions even though an understandable rule with predictable consequences may be normatively suboptimal.[294]

B. *The Political Economy of Notice Filing*

As applied, economic arguments about notice filing have been fairly crude and somewhat counterintuitive. After all, intuitively, we might think that notice filing is an efficient method of conveying information about property, especially to those outside of the debtor's immediate community. This, however, is not how our thinking has developed.

1. *Revenue Theory*

The crudest argument against notice filing involves the upfront, direct costs of the systems: namely, that these systems are covert sources of revenue for the government. There are many who view all schemes to require the recordation of interests in personal property as little more than state confiscation.[295] This is because most such regimes require the payment of a filing fee when the interest is recorded. Professor Bowers, for example, has characterized the filing system under Article 9 as "little more than a rip-off"[296] because "[t]he market for information could probably efficaciously do whatever the filing system bureaucracies do and at a lesser aggregate resource cost."[297] On this view, the UCC-1 system is simply the worst form of rent seeking, plagued by incompetent and indifferent bureaucrats who happen to be the brothers-in-law of politicians or obligees of political favors.[298]

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294 *See* Harris & Mooney, *supra* note 293, at 1363.

295 *See* Alces, *supra* note 3, at 680; Bowers, *supra* note 48, at 724.

296 Bowers, *supra* note 48, at 722.

297 *Id*. at 725. Bowers argues both that notice filing itself is little more than a tax on secured lending, *id*. at 733 ("The filing system consequently operates as if it were a tax on secured transactions."), and that, if any notice system were appropriate, the market would better provide this information than the government. *Id*. at 734 ("A properly privatized system, for example, encourages those who own the system to adopt any advantageous technologies, without a legislative mandate.").

298 *Id*. at 724.

There is no question that these systems are important sources of revenue for the states and localities that maintain them, and this has long been true.[299] Some of the earliest recordation statutes were enacted largely, if not wholly, on the theory they would feed the public fisc. One of the earlier recording statutes, the Statute for the Enrollment of Bargains and Sales promulgated under Henry VIII, requiring the recordation of transfers of title to real property, was allegedly intended as a revenue statute.[300] Professor Mooney has indicated that the same can be said of the first fraudulent conveyance statute, the Statute of 13 Elizabeth, which, he argues, was "intended in large part as a revenue measure."[301]

To characterize notice filing as a deal tax is, of course, to stigmatize it. Most commercial lawyers view taxes suspiciously, regardless of the value one might ascribe to good government. Yet, the proper question is not whether filing imposes costs—it imposes many—but whether it is worth the price paid. For the reasons discussed more fully below, sub rosa taxation cannot be a complete, or even particularly good, explanation for the rise and persistence of public notice systems.

First, if raising revenue were the only or most important goal of filing systems, one would expect that legislatures would never have enacted the revisions to Article 9 or the securitization facilitation acts, all of which tend to reduce or eliminate the obligation to file revenue generating notice in commercial finance transactions. Indeed, one of the reasons Article 9 is viewed as a triumph of efficiency is the fact that it reduced the obligation to file financing statements in multiple states or on a county-by-county basis—often required under former law—which necessarily reduced aggregate revenue to the state filing authorities.[302]

Second, and perhaps more important, there are, as discussed *infra*, a number of plausible substantive rationales for requiring public notice of security interests.[303] It would appear, for example, that notice filing developed as a proxy for information about property that would otherwise

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[299] Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2273 n.1 (1994) (indicating under former Article 9, UCC-1 filing system produced net gain to states of between $300,000,000 and $400,000,000 annually).

[300] *See* Bowers, *supra* note 48, at 731-32 (citing Statute of Enrollments, 1535, 27 Hen. 8, c. 16).

[301] Mooney, *Myth*, *supra* note 33, at 726 n.162 (citing 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 61b, 61c, at 89-93 (rev. ed. 1940)).

[302] Prior law—including earlier iterations of Article 9—was generally viewed as requiring more filings in more offices than revised Article 9 because, among other reasons, former law occasionally required that financing statements be filed not only at the state level, but also by county. *See* U.C.C. § 9-401 (2000).

[303] *See supra* Part IV.

be readily available in tightly knit communities.[304] While we do not know the costs of this information in all cases, we know that as a general matter, property rights are, or should be, cheaply and readily discoverable. Moreover, the availability of such information—and the fact that it must be made available—may have important behavioral effects that have not been accounted for.

In short, it is difficult to imagine that legislatures are able to enact covert revenue regimes without any supporting principle. These rationales may vary in force, but they all suggest that raising revenue alone cannot explain why public notice is adjunct to certain types of property transfers.

2. Rational Apathy: Charlie Don't Surf

A second argument against notice filing focuses on the benefit side of the equation and argues that few actually care about notice filing—especially those historically characterized as its principal beneficiaries: unsecured trade creditors. Except for actual or potential secured creditors—those who are said formally to "rely" on the debtor's property—the general population of creditors is apathetic to the information provided by the notice filing system—and rationally so.

Professor White, for example, has argued that certain members of the presumed audience for financing statement information could not, in fact, care less:

> Neither the plumber, carpenter, accountant, Commonwealth Edison nor any other thousands of general creditors check the files to determine who has a financing statement on file before it decides whether it will extend unsecured credit in the form of the sale of goods or services. In the words of the trade, these are "non-reliance creditors" and are not entitled to protection of a lack of filing because they would not rely on it in any case.[305]

Professor Baird similarly claims "the notice filing system of Article 9 provides virtually no assistance to unsecured creditors. Parties without ownership interests in the debtor's property rarely check the filing system, and if they do, they rarely learn anything."[306]

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[304] *See supra* Part IV.B.

[305] White, *Wasteful Litigation*, *supra* note 119, at 827.

[306] Baird, *Ostensible Ownership*, *supra* note 23, at 55. This is a curious statement. It is true the UCC defines secured creditors as a species of "purchaser," lumping them together with those who

Professor LoPucki has offered a slightly more systemic gloss, arguing that unsecured creditors often do little more than "cash-flow surf."[307] As discussed *supra*, cash-flow surfing happens when unsecured creditors make small, short-term extensions of credit, hoping that the debtor will be able to pay the debt from cash flow in the ordinary course.[308] These creditors may reason that the debtor's assets are already fully encumbered, or that they are worth nothing, or that it is simply not worth making a credit decision based on such complex analyses. Apathy to the information produced by the system is rational because learning about what is out there costs more than it is worth. The unsecured creditor expects to be repaid not because it relies on the value of any particular asset, but as the result of "a combination of nonlegal pressures on the debtor."[309] The involuntary creditor—the tort claimant or terminated employee—is certainly not going to care much, ex ante, about what the public record says about nonpossessory interests in the debtor's property. Having not chosen to extend credit, involuntary, "non-adjusting," creditors can hardly be said to have relied on a debtor's assets or publicly available information about those assets.[310]

Those who assert a general indifference to filed notice are often quick to distinguish between two hypothetical audiences. While trade and other "simple" creditors will not consult the record, other more sophisticated creditors—in particular, secured creditors—will.[311] The claim is thus not usually that the notice filing system should be dismantled entirely, only that it should not be geared to an audience that does not use it.[312] Notice should matter only to "reliance" creditors, who are presumed to be those who have taken security or similar interests in a debtor's property.[313]

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acquire their interests by sale or "any other voluntary transaction creating an interest in property." U.C.C. § 1-201(b)(29) (2003). But most people who think about commercial finance law appear to recognize that secured transactions are different in kind from "ownership."

307 *See* LoPucki, *Creditor's Bargain*, *supra* note 131, at 1923, 1938-39.

308 *Id*. at 1924.

309 *Id*. at 1941.

310 Professor Gilmore has observed that some of the drafters suggested that no one—not even lenders—truly relied on the pre-Code notice filing systems. Rather, the decision to extend credit was based "not on public records, but on financial statements—balance sheets and profit and loss statements." GILMORE, *supra* note 8, at § 15.1, at 463. In his view, the "[p]ublic files . . . will be rarely consulted." *Id.*

311 *See* discussion *supra* notes 139-41.

312 *See supra* notes 305-06. Professor Schwartz's theory of a "true FT" priority system would, as discussed *supra* notes 252-90 and accompanying text, appear to be an exception.

313 As Douglas Baird argued,

Professor Baird has argued that "general creditors rely only in part on the debtor's assets when extending credit. General creditors base their decision to lend on the debtor's general financial health, of which a present or potential encumbrance on the debtor's property is only one factor."[314] Moreover, he claimed, "[c]ases in which creditors decide to lend because of their mistaken belief that an asset is unencumbered are rare."[315] Thus, he concluded, "the needs of general creditors neither justify the costs of the present filing system nor explain its contours."[316]

Arguments against notice filing based on claims about who does or does not rely on it are curious and troublesome for at least three reasons. First, these are often empirical claims about actual behavior in the real world. Professors White and Baird may be correct that "the dross of Article 9" (White's colorful phrase)[317] are wholly indifferent to the presence or absence of filed notice about nonpossessory interests in a debtor's property, whether because they make their credit decisions on other grounds or because they have no choice at all. But they may also be wrong. It may, in fact, be the case that involuntary creditors check the financing statement system, not when they incur their claims, but when they make decisions about whether to sue, settle, or try a case. Indeed, most claims about who the audience is for this information should be empirically verifiable. Yet, these claims have not, to date, been tested, at least in any rigorous and public way.

Second, there is reasonably good anecdotal evidence that many less traditional lenders use the system for a variety of purposes. In certain transactions, parties may use these systems as bulletin boards to ward off those who might try to take an interest in the debtor's property, even though the filers themselves have no such interest. For example, Edwin Smith, a leading practitioner, has indicated that a lender benefiting from a "negative pledge" might file a financing statement, even though such a

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> the notice filing system of Article 9 provides virtually no assistance to unsecured creditors. Parties without ownership interests in the debtor's property rarely check the filing system, and if they do, they rarely learn anything. Article 9's filing system principally serves the interests of *secured* creditors. . . . A notice filing system . . . sorts out property claims among those who have or seek property claims; its function is not to give the world at large notice of security interests.

Baird, *Ostensible Ownership*, *supra* note 23, at 55.

[314] *Id*. at 60.

[315] *Id*. at 60.

[316] *Id*. at 62.

[317] White, *Wasteful Litigation*, *supra* note 119, at 827.

transaction would not necessarily result in the staking of a claim by the lender.[318]

Paul Shupack has suggested that in certain contexts, trade creditors rely on a clean record in deciding whether to ship to a debtor who has promised not to encumber its inventory.[319] Trade creditors, Shupack observed, might "view the debtor's use of inventory as security as a public statement of the debtor's financial distress, particularly if the debtor had not previously done so."[320] Others have suggested that equipment lenders would "trawl" the financing statement records, looking for financing statements that were about to expire.[321] Reasoning that the loans covered by the financing statements were about to expire, they might then contact the debtors indicated in those financing statements in order to "sell" replacement financing.[322] Professor Carlson has argued that the notice filing system may have performed a kind of antitrust

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318 Smith explained:

> I have seen this technique used on various occasions for negative pledge agreements and subordination agreements. In the case of a negative pledge agreement, of course, it is in the interest of the creditor in whose favor the negative pledge is granted to put other creditors on notice of the existence of a negative pledge. In the case of a lender filing a subordination, it is in the interest of the debtor to provide comfort to a new senior creditor extending credit to the debtor that the senior creditor will in fact be senior. Although neither example fits squarely into the original purposes of the Article 9 filing system, it seems to me that the commercial "bulletin board" approach, by providing even additional information about the debtor than that required by the Article 9 filing system, is useful. And, as the examples indicate, can benefit either the creditor or the debtor depending on the particular circumstances.

Alces, *supra* note 3, at 696 (quoting Letter from Edwin E. Smith, Bingham, Dana & Gould, to Professor Peter A. Alces, Marshall-Wythe School of Law, The College of William and Mary 1-2 (July 31, 1991)); *see also* Posting of Kenneth C. Kettering, *Filing a Financing Statement on a Negative Pledge*, ucclaw-l@lists.washlaw.edu. (Feb. 8, 2005), *available at* http://lists.washlaw.edu/mailman/private/ucclaw-l/2005-February/subject.html) ("I agree that such a filing can't hurt and might help Lender-1, and I'm surprised that I didn't see more such filings when I was in private practice.") (copy on file with author).

319 Paul M. Shupack, *Preferred Capital Structures and the Question of Filing*, 79 MINN. L. REV. 787, 803-07 (1995).

320 *Id.* at 806. This makes sense only if the trade creditors do not understand purchase-money priority, or rationally conclude (for any number of reasons) that the mechanics involved in obtaining that "super" priority are not worth the effort. Shupack suggests certain trade creditors may not find purchase-money priority attractive because, among other things, "these sellers have a visceral feeling that the inventory should be 'theirs' because they supplied it . . . ." *Id.* at 805.

321 *See* e-mail from Howard Ruda, attorney, to author (July 21, 2003) ("There was a time (and perhaps still is) when UCC (and predecessor) records were searched for marketing information.") (on file with author).

322 *Id.*

function, preventing local lenders from gaining a strangle-hold on borrowers, to the exclusion of national lenders.[323]

Third, and perhaps most important from a policy perspective, there are reasons other than current, direct usage that justify the system. Most prominent of these would be the credit reporting systems maintained by firms like Dun & Bradstreet.[324] As discussed *supra*, it is likely that even if general unsecured creditors do not routinely check the records maintained by the secretary of state when deciding whether to extend credit, they may well consult services whose information does depend, in part, on this information.[325] While these systems may be expected to continue to grow in sophistication, there is no reason to believe they would be more effective if they have access to less, and less reliable, information about the companies they cover.

3. Redistribution Theory

Perhaps the greatest reason to challenge the view that creditors are apathetic is that it is disingenuous. That is, the real concern of those who grouse about the notice filing system is not that creditors ignore it, but that the penalty for failing to comply with it is excessive. As discussed above, this penalty derives from the strong-arm power of Bankruptcy Code § 544(a), which provides that the bankruptcy trustee "shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by . . . a creditor that . . . obtains . . . a judicial lien" on the property in question.[326] This power has often been used arbitrarily, in the sense that a lender might lose its lien even though there was, in fact, no real information failure.[327] Thus, Professor Bowers has argued, "[t]here is good reason to believe that bankruptcy legislation is

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[323] Professor Carlson explained:

> By providing information to the national credit market, Article 9 filing improves competition in the credit market generally . . . . [T]he system socializes a useful screening function, thus depriving local creditors of an advantage over national creditors. But this rationale presumes a context that may no longer be empirically correct. For example, where it is generally known that assets are always encumbered by security interests, a filing system may serve no useful screening function. Or, the filing system may simply cost too much, as many now allege. In these contexts, filing systems might violate the logic upon which they are founded, in which case reform is in order.

Carlson, *Debt Collection*, *supra* note 120, at 831.

[324] *See supra* discussion accompanying note 130.

[325] *See supra* notes 130-38 and accompanying text.

[326] 11 U.S.C. § 544(a)(1) (2000).

[327] *See supra* notes 119-24 and accompanying text.

intended mainly to chisel secured creditors out of their bargains."[328] Notice filing has existed "mostly [as] insurance against bankruptcy"[329] or as a "bankruptcy tax" on secured transactions.[330]

There is no question that the strong-arm power to redistribute wealth imposes costs on certain parties. The important question, however, is whether the costs imposed by the strong-arm power exceed the benefits that might flow from compliance with the notice filing rules. I think, in this instance, the balance sheet becomes difficult to assess, especially when there is no secret lien. Where the community of creditors knows or has reason to know that a debtor's property is encumbered, it is difficult to see the efficiencies that would result from ex post avoidance on purely technical grounds. By definition, cognizant creditors will choose to extend credit informed of the economic risks that the secured party had priority; it is not clear how the parties or society benefit economically if these creditors are not required to internalize these risks because a court later avoids the security interest for technical reasons not apparent or relevant to the parties ex ante.

Conversely, where a secured party or other investor has priority in the debtor's assets that is not known or readily discoverable, the more formal attributes of the notice filing system may become important for the same basic reasons. Voluntary creditors that extend credit based on significant information asymmetries—who, for example, lend against secretly encumbered data or intellectual property—are being forced to transfer value to secured creditors who have no rational incentive to make their property interests known. This is because the holder of the secret lien might want its debtor to acquire as much property as possible from creditors who would not otherwise choose to lend or sell on credit if they knew the debtor's true economic risks.

The problem with all of the economic arguments marshaled against notice filing thus far is that they are largely speculative. They are based on assumptions made about human behavior (who looks at the financing

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[328] *See* Bowers, *supra* note 48, at 733.

[329] *See* White, *supra* note 1, at 531. Professor White's statement is a bit tendentious because filing is insurance against only one form of loss: that caused by the strong-arm power. But, secured creditors often lose their collateral or its value. The ordinary course rules expressly contemplate the loss of rights in collateral by "cutting off" security interests when there has been a complying (e.g., "ordinary course") disposition. *See* U.C.C. §§ 9-320, 9-321 (2003). Similarly, the security interest itself is worth only as much as the underlying property. While collateral may insure against the risk the debtor will not have sufficient unencumbered assets to service the debt, there is little about filing that "insures" the value of the security interest.

[330] *See* Bowers, *supra* note 48, at 733.

statement records), cognition (what will they understand from their review), and risk preferences (creditors may, or may not, adjust based on the information thus obtained). An empirical analysis may well fill in some of the blanks that many have chosen to ignore. Yet, even if an empirical analysis reveals who uses the notice filing system, it does not tell us whether they should, or whether notice filing systems produce benefits or costs not yet captured by the economic analysis.

IV. THREE ARGUMENTS AGAINST SECRET LIENS AND IN FAVOR OF NOTICE FILING

Until we have an empirical analysis of the notice filing systems, it remains important to understand what is lost by moving away from them. This Part develops three arguments against secret liens and in favor of notice filing that have not yet been considered. First, this Part assesses the role of notice filing through the lens of recent developments in property theory, which emphasize the information costs of property rights that are difficult to discover. Second, it considers the role that information about property plays more generally in commercial communities. Finally, this Part applies some of the literature on cognitive theory to the problem of secret liens and notice filing.

A. Neoclassical Property Theory and Information Costs

To tolerate secret liens is to challenge a deep intuition in our law, which links property rights to public notice obligations. Strong claims about this intuition have been made by, among others, Richard Epstein,[331] Carol Rose,[332] Douglas Baird, and Thomas Jackson.[333] Most recently, Thomas Merrill and Henry Smith have elaborated on this intuition in what may be characterized as a neoclassical approach to property law theory.[334] They argue that property rights are unique because they create "universal duties" that "are broadcast to the world from the [property] itself."[335]

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[331] *See, e.g.*, Richard A. Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. CAL. L. REV. 1353, 1355-56 (1982).

[332] *See, e.g.*, Rose, *Possession, supra* note 22, 78-79.

[333] *See, e.g.*, Baird & Jackson, *Information Uncertainty*, *supra* note 23, at 312 ("Filing systems work because the legal rules provide not only a benefit to a person who desires to acquire a property right but also a corresponding responsibility. One is obliged to stake one's claim in the filing system so that future parties will be able to find it.").

[334] *See* Merrill & Smith, *Law and Economics*, *supra* note 12.

[335] *Id*. at 359.

1. The Numerus Clausus

Neoclassical views about the notice function of property are rooted in the "numerus clausus," the idea that property rights come in a fixed and closed number of forms. "Property law," Merrill and Smith argue, "requires that the parties adopt one of a limited number of standard forms that define the legal dimensions of their relationship; generally speaking, these are mandatory rules that may not be modified by mutual agreement."[336] The number (numerus) of property forms is, in the vernacular, closed (clausus) because "common-law courts will not enforce an agreement to create a new type of property right."[337]

The numerus clausus appears to be a well-articulated feature of many civil law jurisdictions.[338] In the common law, however, its role is more opaque. Although courts and lawyers are characterized as hostile to the numerus clausus, Merrill and Smith contend they "routinely abide by the principle, even if they are unaware of its existence."[339] For example, as to estates in land, "courts enforce the *numerus clausus* principle strictly. . . . The menu of forms is regarded as complete and not subject to additions."[340] With respect to personal property, Merrill and Smith claim the list is even narrower.[341] They argue that the chief exception—the one area in which courts will respect novel claims of property rights—is in the intellectual property arena.[342] Here, "judicial creativity in fashioning new intellectual-property interests has been sanctioned" in recognizing rights of publicity and misappropriation of information.[343]

The principal explanation for the sub rosa vitality of the numerus clausus is economic, oriented around the inefficiency that stems from the excessive fragmentation of rights or rights holders.[344] Merrill and Smith

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336 Merrill & Smith, *Interface*, *supra* note 19, at 776.

337 *See* Merrill & Smith, *Optimal Property*, *supra* note 19, at 5.

338 *See id*. at 4-5 (In civil law countries the numerus clausus is "widely acknowledged by commentators as being a substantive limitation on the definition of property . . . .").

339 *Id*. at 8. "Scholars and judges tend to react to manifestations of the *numerus clausus* as if it were nothing more than outmoded formalism." *Id.* at 6.

340 *Id*. at 13.

341 *Id*. at 17 ("Personal property is restricted to fewer available forms of ownership than real property.").

342 *Id*. at 19.

343 *Id*.

344 Merrill and Smith appear concerned chiefly with the fragmentation of rights themselves. A related problem is the fragmentation of rights amongst numerous rights holders. *See, e.g.*, Michael A. Heller, *The Dynamic Analytics of Property Law*, 2 THEORETICAL INQ. L. 79, 87 (2001); Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 633-40 (1998).

take the economic explanation one step further, arguing that we restrict property forms not out of concerns about fragmentation, per se, but about information costs associated with the creation of excessively idiosyncratic property rights ("fancies").[345] Thus, Merrill and Smith believe that the need for the numerus clausus "stems from an externality involving measurement costs: Parties who create new property rights will not take into account the full magnitude of the measurement costs they impose on strangers to the title."[346]

The information costs of idiosyncratic property forms explain for Merrill and Smith the underlying basis of the numerus clausus.[347] "One way to control the external costs of measurement to third parties is through compulsory standardization of property rights."[348] According to Merrill and Smith, the standardization of property forms imposed by the numerus clausus

> reduces the costs of measuring the attributes of such rights. Limiting the number of basic property forms allows a market participant or a potential violator to limit his or her inquiry to whether the interest does or does not have the features of the forms on the menu. Fancies not on the closed list need not be considered because they will not be enforced. When it comes to the basic legal dimensions of property, limiting the number of forms thus makes the determination of their nature less costly. The "good" in question here might be considered to be the prevention of error in ascertaining the attributes of property rights. Standardization means less measurement is required to achieve a given amount of error prevention. Alternatively, one can say that standardization increases the productivity of any given level of measurement efforts.[349]

There is, on this view, an "optimal" number of property forms, and this number is determined by the information costs associated with excessively idiosyncratic forms of property. On the one hand, costs in

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[345] Merrill and Smith refer to idiosyncratic property forms as "fancies" after the opinion in *Keppell v. Bailey*, 39 Eng. Rep. 1042, 1049 (Ch. 1834) ("[N]ovel forms of property cannot 'be devised and attached to property at the fancy or caprice of any owner.'"). Merrill & Smith, *Optimal Property*, *supra* note 19, at 25 nn.102-04.

[346] Merrill & Smith, *Optimal Property*, *supra* note 19, at 26-27.

[347] Merrill and Smith use the example of a one hour time-share in a wrist-watch. *Id.* at 27. Note that UCC, Article 2A, would appear to recognize the time-share in the watch as a lease. *See* U.C.C. § 2A-103 (2000). UCC § 2A-103(j) defines a lease as "a transfer of the right to possession and use of goods for a term in return for consideration." There is no apparent reason why the "term" of the lease could not be every Monday for one year. It might be fanciful and inefficient, but it is permissible.

[348] Merrill & Smith, *Optimal Property*, *supra* note 19, at 33.

[349] *Id*. at 33-34 (footnotes omitted).

error and measurement would be lowest, Merrill and Smith observe, in a highly regimented system, which recognizes only a single, simple form of property, such as the fee simple absolute.[350] However, frustration costs arising from stymied creativity would be quite high. On the other hand, a system of unfettered customization of property forms—pure contract—may have low frustration costs—it is difficult to be frustrated if the law recognizes anything you do—but high costs of verification and measurement. Both the parties that created the fancy, and others who might try to discover what it is and what rights are held in it, will expend large sums in ascertaining and managing these rights. The social cost of limitless customization of property rights is simply too great. The optimal level of customization—the number and type of fancies permitted by the numerus clausus—is somewhere in between and should result in the lowest information cost.

The information problems addressed in this Article are not specifically about novel property forms and, thus, not directly about the numerus clausus. Neither the Article 9 security interest nor, arguably, asset securitization depend for their effectiveness upon the recognition of novel property forms.[351] Yet, the underlying informational problem is the same: Notice filing systems may channel transaction forms in ways that pure contract would not. For example, lawyers likely structure commercial finance transactions bearing in mind the specific collateral types established by Article 9.[352] Article 9 does not, as noted above, rigidly require that secured transactions within its scope be described according to the property designations established by statute. Yet, it would appear that lawyers are very mindful of these categories and intentionally depart from them only rarely.[353] To the extent these categories create shorthand descriptions of specific types of rights with respect to specific types of property, they perform a function at least analogous to that of the numerus clausus. To the extent we abandon

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350 *Id*. at 39-40.

351 *See id*. Note, however, that asset securitizations may present a challenge to the numerus clausus to the extent the problem of true sale generally challenges established property categories.

352 I base this claim not only on personal experience, but also on repeated and extensive discussions on the UCC-LAW listserv about the proper methods of describing collateral and the risks of using non-UCC terms in collateral descriptions. *See, e.g.*, Posting of Michael Evan Avidon, *UCC Financing Statement Collateral Descriptions*, to ucclaw-l@lists. washlaw.edu (Dec. 9, 2004), *available at* http://lists.washlaw.edu/mailman/private/ucclaw-/2004-December/ 010996.html (copy on file with author).

353 *Id*.

notice filing, therefore, we should drive up the cost of obtaining information about the types of, and interests in, property.

Merrill and Smith's view of the existence of, and rationale for, the numerus clausus is not without critics. In a recent article, Henry Hansmann and Reinier Kraakman question the neoclassical assertion that the list of property forms is closed or that there may be an "optimal" number of property forms.[354] Rather, they argue "[t]he law's limitations on property rights take the form not of standardization in a discreet number of well-defined forms, but rather of regulation of the types and degree of notice required to establish different types of property rights."[355] They argue that non-standard property rights are recognized by the common law, but "are simply governed by highly unaccommodating verification rules that place a heavy burden on the holder of the right to provide notice to third parties."[356] They argue that "[t]he optimal standardization theory makes little sense when applied at the category level."[357] By this, they appear to mean that a highly idiosyncratic form of property right in one category—say, intellectual property—should not create meaningful information costs for property in another category, such as real estate.[358] Even within categories, increasing the number and complexity of rights will not necessarily increase costs significantly, assuming "the same verification rules are used" for types of rights within the given category.[359]

2. *Property as Information*

Perhaps the key point about the numerus clausus is informational: The forced standardization of property forms creates a kind of shorthand which, in turn, reduces information costs. "When we encounter a thing that is marked in the conventional manner as being owned," Merrill and Smith write, "we know that we are subject to certain negative duties of

354 *See* Hansmann & Kraakman, *supra* note 19.

355 *Id*. at 374.

356 *Id*. at 399.

357 *Id*. at 401.

358 *Id*.

359 *Id*. Nor does the numerus clausus account for the creation and destruction of property forms over time. Michael Heller, for example, has observed that property law in Blackstone's time recognized a variety of forms that have since fallen away. Michael Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1176 n.62 (1998) ("In Blackstone's time, the *numerus clausus* was much more numerous, populated with incorporeal hereditaments such as corodies and advowdsons that no longer exist. . . . Over time, these forms were pared down to the streamlined list that exists today.") (citations omitted).

abstention with respect to that thing . . . ."[360] Because the thing has been "marked," "we know all this without having any idea who the owner of the thing actually is."[361] Property law creates "universal duties" that are "broadcast to the world from the thing itself."[362]

In one sense, the problem of secret liens challenges this claim. If property, in fact, always conveyed sufficient information to "broadcast universal duties," we would never have secret lien problems. The mere existence of property would somehow warn those who might otherwise be duped. Yet, we know that history is replete with examples of such mistakes, which often arise from secret liens. Perhaps the claim is therefore more modest, i.e., that property law essentially "presents a massive coordination problem."[363] As Merill and Smith discuss,

> [i]f the legal system allowed in rem rights to exist in a large variety of forms, then dutyholders would have to acquire and process more information whenever they encountered something that is protected by an in rem right. If in rem rights were freely customizable—in the way in personam contract rights are—then the information-cost burden would quickly become intolerable. Each dutyholder would either incur great costs in informing herself, or would be forced to violate property rights wholesale, defeating the benefits of security, investment, and planning that these rights were meant to secure.[364]

The problem is that our commercial finance law would appear inclined to increase—not decrease—the costs of discovery precisely because transactions are increasingly customizable and decreasingly subject to mandatory notice rules. To the extent that contract alone—whether the control agreement or the pooling and servicing agreement in a securitization—effectively transfers whole or partial interests in property, we either make these more expensive to discover or more likely subject to violation. To the extent that Article 9 and securitization facilitation statutes govern the creation and transfer of property rights, they do not, contrary to Merrill and Smith's claim, "reduce the widespread information-gathering and processing costs imposed on third

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360 Merrill & Smith, *Law and Economics*, *supra* note 12, at 359.

361 *Id*. "Marking" was at least one of the problems encountered by Twyne in his eponymous case. *See* Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601). *Twyne's Case* is discussed *supra* in Part I.B.1.

362 Merrill & Smith, *Law and Economics*, *supra* note 12, at 359.

363 *Id*. at 387.

364 *Id*. (footnote omitted).

parties . . . ."[365] Rather, at least for the transactions discussed in this Article, they would appear to increase these costs.

Although Hansmann and Kraakman disagree with the neoclassical conclusion that the forms of property rights are, and economically-speaking must be, limited, they whole-heartedly endorse the link that Merrill and Smith make between property rights and notice, which they call "verification."[366] However, Merrill and Smith err, they argue, by suggesting that notice is required to facilitate communication among persons who transact in property rights.[367] Hansmann and Kraakman argue that limitations on the types of property "facilitate verification of ownership of the rights offered for conveyance."[368] Notice and property rights are correlated because "[t]he degree of notice required and the extent to which the law affirmatively facilitates the giving of notice vary across different types of property rights according to the utility of the partitioning and the costs of giving notice."[369] In other words, "[b]ecause the benefits of partial property rights are often low and the costs of verifying those rights are generally high, property law necessarily takes an unaccommodating approach to all but a few basic categories of partial property rights."[370]

Perhaps the most important—or most common—partial property interest is the security interest. If the trend away from notice filing is as described *supra* in Part II of this Article, then we are in fact taking an increasingly accommodating approach to increasingly hard-to-discover property rights. Neither Merrill and Smith nor Hansmann and Kraakman express a strong opinion about how property information should be disseminated. Merrill and Smith seem to believe, for example, that notice filing systems generally are cheap sources of information about property rights.[371] They offer as an example the Article 9 financing statement system which, they claim, "allowed the loosening of the earlier quite strict limits on the types of security interests permitted."[372]

It may be that the neoclassicists are not commercial lawyers, and so they do not focus on the technical details of trends in financing techniques

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365 *Id*.

366 *See* Hansmann & Kraakman, *supra* note 19, at 382-85.

367 *Id*. at 374-75.

368 *Id*. at 374.

369 *Id*. at 374-75.

370 *Id*. at 375.

371 *See* Merrill & Smith, *Optimal Property*, *supra* note 19, at 40 ("[R]egisters of interests in real property, that is, recording acts . . . lower[] the costs of notice . . . .").

372 *Id*. at 42 (footnote omitted).

and how these trends might influence, or be influenced by, developments in thinking about property law. But it may also be that the trend in commercial finance law is mistaken to the extent it ignores the information cost lessons of the neoclassical analysis. If we are to take the neoclassical position seriously, it invites us to see how the abandonment of notice filing creates two related categories of information cost. First, as suggested above, notice filing may perform a channeling function that creates a shorthand means of describing information about property.[373] Lawyers who deviate from the UCC's collateral types in their financing statements risk avoidance under the strong-arm power.[374] If, however, they have nothing to file at all, then the parties are (or should be) free to describe the collateral idiosyncratically, even if the description might not make sense to (or be discoverable by) third parties.[375] Although it is obviously possible to discover and interpret such transactions and interests via contract and due diligence, it is likely to be more costly the more stylized and elliptical the information is.

Second, the secret-lien-creating transactions discussed above subvert the basic information function of property. In a world where property increasingly has no physical attributes such that it "broadcasts" anything about or from itself, it becomes important to find cheap and effective means of managing the information costs created by the massive coordination problem that Merrill and Smith identify.[376] While we may someday live in a world in which the Dun & Bradstreets have computers that are sufficiently sophisticated and reliable to render notice filing vestigial, we are not there yet. Those who, like Alan Schwartz, view skeptically the public notice filing system may be correct that in a better world "good" debtors will tell the truth and the costs of ferreting out "bad" debtors will be comparatively low.[377] Today, however, it would seem that the neoclassicists have the intuitively more appealing position: The increased use of contract (e.g., through control security interests and

373 *See supra* notes 133-35 and accompanying text.

374 *See supra* notes 119-24 and accompanying text.

375 TKO Equip. Co. v. C&G Coal Co., 863 F.2d 541, 545 (7th Cir. 1988) (Easterbrook, J.) ("Under the prevailing will theory of contract, parties, like Humpty Dumpty, may use words as they please. If they wish the symbols 'one Caterpillar D9G tractor' to mean '500 railroad cars full of watermelons,' that's fine—provided parties share this weird meaning."); *see* Smith, *supra* note 19, at 1183-84 (discussing the *TKO* case and observing, "[a]s is the concern with the *numerus clausus* principle and the recording acts, subsequent purchasers and lenders cannot be expected to share the secret knowledge of the parties. And [as] this concern becomes more acute, the broader this third-party audience becomes.").

376 *See* Merrill & Smith, *Law & Economics*, *supra* note 12, at 387.

377 *See supra* notes 271-90 and accompanying text.

asset securitization) will increase the costs of discovering these property interests.

B. Merchant Community Norms

Increased information costs are not the only troublesome byproduct of the trend away from notice filing. There are other, less overtly economic, costs created by this trend. One involves the role of notice filing systems in and across contemporary commercial communities.

As discussed *supra* in Part I, one way to understand the rise of notice filing systems is as a response to increasing social complexity: As the world became more complex, more formalized information systems (e.g., notice filing) arose both to convey information about property and to control members' uses of that property. For example, the title registry systems used in Massachusetts before the American Revolution existed both to deal with fraudulent conveyances and to regulate the admission of new members to the community.[378] Notice filing can be seen in part as a response to community transgressions that may flow from separating property from information about it. But community also implies a set of understandings about the development and distribution of information. Those within a community, the idea seems to be, will have access to, and the means of interpreting, certain kinds of information. Those who are not members of the community will not.

We know something about how at least some contemporary communities deal with information about the property rights of their members. The work of writers such as Robert Ellickson[379] and Lisa Bernstein[380] suggest that community structures can often be a proxy for more formal information-generating rules which might govern notice filing.

Consider *Order Without Law*, Ellickson's study of ranchers in Shasta County, California in the early 1980s.[381] Ellickson studied what may be

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[378] *See* discussion *supra* notes 50-54.

[379] *See* sources *supra* note 20. Although Ellickson has made an enormously valuable contribution, he was not the first to study property rights in small communities. *See, e.g.*, Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347, 350 (1967) (studying family property in beaver-hunting territories among the Montagnes in eastern Canada with the advent of the fur trade).

[380] *See supra* note 21 and accompanying text. Like Ellickson, Bernstein's work grows out of a rich tradition of empirical legal analysis, which emanated generally from Yale Law School and found its most important early expression in Stewart Macaulay's work, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

[381] *See* ELLICKSON, ORDER, *supra* note 20.

the seminal form of property problem—boundary disputes among adjacent landowners, specifically among ranchers and farmers[382]—that Coase imagined in his landmark 1960 article, *The Problem of Social Cost*.[383] In attempting to find out how a particular group of individuals addressed the problem of social cost, Ellickson found that neither traditional doctrine nor received economic wisdom would predict behavior accurately.[384] As the title of the book suggests, Ellickson found that members of this fairly close-knit community often declined to resort to formal legal action when boundary disputes arose amongst its members.[385]

But that is not to say that formal law had no role in resolving disputes in Shasta County. Ellickson observed that when the cattle wandered off the fields and onto the highway, California tort law—and not the communal norms of cooperation—would likely resolve any dispute that arose between the owner of the cow and the driver of the car that might have occupied the same point in space and time.[386] While the ranchers may not have fully understood the nature of their liability—they believed, despite repeated losses, that "the motorist who hits a bovine in open range 'buys the cow'"[387]—the rest of the world did. Furthermore, this liability was determined not by the norms of the Shasta County community, but by California law on negligence, animals, and insurance.[388]

Based on this, among other things, Ellickson developed an intuitively appealing hypothesis: "[M]embers of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workday affairs with one another."[389] In simpler terms, Ellickson observed, "members of tight social groups will informally encourage each other to engage in cooperative behavior."[390] But, the corollary would have to be that informality or norms-governed

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382 *Id.*

383 *See* Coase, *supra* note 232.

384 ELLICKSON, ORDER, *supra* note 20, at 82.

385 *Id.*

386 *Id.*

387 *Id.* Or perhaps they failed to appreciate that highways were not "open range." *Id.* at 103.

388 *Id.* at 82.

389 *Id.* at 167 (emphasis omitted) (footnote omitted).

390 *Id.* Ellickson recognized this position resonated with works of writers as diverse as Alexander Bickel, Lon Fuller, Friedrich Hayek, Thomas Schelling, "and similar scholars who in diverse ways have kept alive the Burkean notion that decentralized social forces contribute importantly to social order." *Id.* at 168 (citations omitted).

rule making would be inappropriate when these conditions—principally the social cohesion condition—were not obtained. Among other things, Ellickson recognized that normatively influenced systems of control might tend to externalize costs to those outside the community.[391] "[N]orms that add to the welfare of the members of a certain group," he noted, "commonly impoverish, to a greater extent, outsiders to that group."[392]

Ellickson did not discuss the secured financing of cattle in Shasta County, so it is not clear whether a more insular, norms-based system applied to the resolution of debtor/creditor disputes or the more formal legal rules were assumed to apply. The suggestion seems to be that within the community, the norms-based regimen would apply. Thus, he observed, "[w]hen a notorious informal debt has been repaid, the party who has been made whole bears an informal duty to tell others that accounts have been squared."[393] But, outside the community, the suggestion seems to be that more traditional, baseline rules of law do and should apply. This is because the informal methods of rule generation and enforcement within the community do not necessarily obtain outside the community.[394] It would be difficult, for example, to imagine that agricultural lenders would rely solely on reputation, gossip, and informal social control to enforce their loans or to make a decision to extend credit. On the other hand, within the group, informal measures may be adequate proxies for obtaining information about a debtor's property.

Lisa Bernstein's study of diamond merchants yielded a similar suggestion. Bernstein sought to understand why diamond merchants, especially those in the New York Diamond Dealers Club ("DDC"), rarely resorted to established legal mechanisms to create contracts or to resolve disputes over them.[395] Unlike Ellickson, Bernstein discussed the role that credit and financing play in the diamond trade.[396] Credit was an important component of sales among diamond merchants, where "bargaining over the term of payment became an important and contentious stage in

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391 *Id*. at 169.

392 *Id*. Ellickson cited, among other things, the treatment of African Americans in the presence of norms of racial discrimination. *Id.*

393 *Id*. at 232.

394 *Id*. at 283 ("As prior investigators have found in other contexts, disputants are increasingly likely to turn to legal rules when the social distance between them increases . . . .").

395 Bernstein, *Diamond Industry, supra* note 21, at 116 ("[T]he diamond industry is unique in its ability to create and, more important, to enforce its own system of private law.").

396 Bernstein characterized diamond markets as both a commodities market and an "implicit capital market." *Id*. at 131.

contract negotiation."[397] According to Bernstein, payment terms, other than cash on delivery, were often thirty or sixty days.[398] These periods often corresponded to the time involved in finishing the stone, so Bernstein surmised that "sellers generally finance most, if not all, of the buyer's (manufacturer's) cash gap."[399]

Bernstein discussed the mechanics of external financing only indirectly. She observed that a fairly small number of banks were involved in the diamond industry because valuing diamonds was often beyond the expertise of most bankers.[400] While diamonds may be valuable property, it would appear their value played only an incidental role when banks decided to extend credit to insiders in the diamond industry. Rather than the collateral value of the diamonds, per se, lenders in Bernstein's study were more concerned with merchant reputation.[401] "[A]lthough defaulting on a loan would hurt any businessman's credit rating," Bernstein observed, "the damage to a diamond dealer is more severe since there are only a few industry lenders and banks must rely to a greater extent on the dealers' reputation in valuing his assets."[402]

One might infer from this that information-generating rules on such things as notice filing did not matter. But it would appear that notice filing does play a part in the financing of diamond transactions, especially vis-à-vis those outside the "community," such as banks.[403] Bernstein observed that many transactions within the industry took the form of consignments—sales where the seller retained title until the buyer resold or returned the goods in question.[404] As under current law, the UCC in the early 1990s provided that a consignor would protect its interest in consigned goods if it filed an effective UCC-1 financing statement adequately describing the goods.[405] If the consignor failed to file an effective financing statement, however, it would lose its rights in the

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397 *Id.*

398 *Id.*

399 *Id.*

400 *Id.* at 155 n.67. Bernstein noted that, at the time of her writing, Merchants Bank of New York was attempting to develop an in-house group of gem experts with access to important intraindustry reputation information. *Id.* at 132 n.38.

401 *Id.* at 154 n.67 (quoting banker as observing "in terms of extending credit a bank has to look at the 3 C's—Capital, Culpability, and Character. At our bank, we think that character is the most important C.").

402 *Id.*

403 *Id.* at 155.

404 *Id.*

405 *See* U.C.C. § 2-326 (2000) (discussing rights of consignment seller); *id.* § 9-102(a)(20) (2003) (defining consignment); *id.* § 9-319 (discussing rights of consignment seller).

goods as against a competing bankruptcy trustee under the strong-arm power or a bank with a perfected security interest in the buyer's inventory.[406]

As a historical matter, Bernstein found that consignment agreements were always concluded orally.[407] However, Bernstein observed, this began to change as dealers discovered they would lose their interest in the consigned goods if the buyer got into financial trouble.[408] Thus, the legal counsel to the DDC advised dealers that the UCC "will give you protection if you adequately describe your diamonds and file a UCC-1 Financing Statement . . . . This will give you a legal leg to stand on if you unfortunately have to seek the return of your merchandise from a bank or a trustee in bankruptcy."[409] Thus, consignment agreements—and in larger transactions UCC-1 financing statements—became part of the diamond industry by the early 1990s.[410]

Bernstein suggested the formal consignment agreement served two important functions: one internal, the other external. Internally, the consignment agreement would function like a bill of sale, providing evidence of what the transaction was supposed to have been in the event of a later dispute.[411] Externally, the formal consignment agreements were critical to demonstrating the intentions of the parties to a court.[412] "[W]ithout them," Bernstein noted, "courts tend to interpret the meaning of an intraindustry consignment agreement in ways that are strongly at odds with industry custom and the intent of the original contracting parties."[413]

Like the ranchers of Shasta County who collide with outsiders, Bernstein's study suggested that informal, community-based methods of setting rules and remedies may be appropriate within a group, but not

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[406] The strong-arm power is discussed *supra* in Part I.B.2. A recent example of this appears in *In re Valley Media, Inc.*, 279 B.R. 105, 132 (Bankr. D. Del. 2002) (holding "unperfected" consignment sellers lost priority to bankruptcy trustee).

[407] Bernstein, *Diamond Industry*, *supra* note 21, at 155.

[408] *Id.*

[409] *Id*. at 155 n.69 (quoting S. Herman Klarsfeld, *Legal Gems*, N.Y. DIAMONDS, May 1988, at 63).

[410] *Id*. at 155 ("[W]hen a dealer gives goods on consignment, a formal consignment memorandum that satisfies the requirements of the [UCC] is now sometimes drawn up to ensure that the [consignment seller's] title to the goods will be recognized by the legal system.") (footnote omitted).

[411] *Id*.

[412] *Id*. at 155-56.

[413] *Id*. at 156.

necessarily outside of it.[414] Community can be a proxy for more formal methods of gathering and disseminating information, such as notice filing systems. Notice filing may not matter to diamond merchants *inter se* because they know—or believe they know—all that is important to know about one another in order to trade internally. But the possibility that their transactions will have to be explained to an outside judge or bank suggests that more formal informational mechanisms are still important.[415] Put another way, while the community of diamond merchants may elect to adopt or reject certain commercial conventions *inter se*, there seems to be no doubt that more formal rules will govern the interface between those within the community and those outside of it.[416] Notice filing may be an informational bridge to the outside world.

The work of Ellickson and Bernstein has two important lessons for the role of notice filing. First, where information about property and other credit-related matters (e.g., reputation for trustworthiness) is readily available to all members of the relevant community, it is not clear that more formal notice filing systems are necessarily useful. If all creditors of a debtor know the debtor's assets are fully encumbered by a first priority security interest, is there any legitimate basis for avoiding the security interest if the financing statement perfecting the interest is somehow technically deficient? If there is no secret lien in fact, who benefits from avoiding the security interest?

Second, and perhaps more important, where there is no information-rich community, in which the existence and extent of property (and other) interests are reasonably well understood, the more formal methods of generating and disseminating information about property (e.g., notice filing) become increasingly important. Thus, in simpler times, when communities were more closely knit, cruder signals about property were or should have been acceptable. On this view, the nonpossessory security interest in *Clow*[417] and the factor's lien in *Ryttenberg*[418] should have survived challenge. Neither case suggests that anyone—within or without the community—lacked knowledge of the security interests in question.

As things become more complex, community structures may break down. Thus, the downstream buyer or licensee of data or intellectual

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[414] *Id*.

[415] *Id*. at 155-56.

[416] *Id*.

[417] *See* discussion of *Clow*, *supra* text accompanying notes 24-31. Recall that *Clow* avoided an unrecorded, nonpossessory security interest.

[418] *See* discussion of *Ryttenberg*, *supra* text accompanying notes 83-85. Recall that *Ryttenberg* avoided a factor's lien despite the posting of a sign at the debtor's warehouse.

property may have to worry about the security interest of a lender several generations prior in the chain of interest, which is not known to the buyer's or licensee's general community and which would not be discoverable by even a reasonably diligent search. Similarly, it is not clear how to address the rights and expectations of those who may come into conflict with a control-perfected security interest. The equipment vendors of the world may be sophisticated enough to understand that their borrower's banks have a right of setoff, which is akin to the bilateral form of control.[419] But would the equipment vendors necessarily understand that they can lose the casualty value of their collateral to an undisclosed third party (e.g., in a trilateral control agreement)?[420]

A similar analysis might inform our thinking about the role of notice filing in asset securitization. Where a transaction is well-publicized—and generally understood by the debtor's community of creditors—it is not clear that notice filing adds much. But the complexity of asset securitization transactions suggests that even if they are public, they may not be well understood.[421] While notice filing will not necessarily explain much about the intricacies of the transaction, it provides some basic information to those outside the community, who may be the parties with the least information about, and poorest understanding of, the deal. It will increase the likelihood that creditors and other interested parties know of the potential existence of the transaction, and by implication its affect on the debtor's assets.

There, nevertheless, remains the objection that the "community" may be indifferent to this information because they do not in fact search the public records.[422] This may be narrowly true.[423] But even if, as many speculate, the unsecured creditor pool does not search the financing statement system,[424] they nevertheless may well rely indirectly on the information that it produces. This is because, as discussed *supra*, the notice-filing system is a link in a much larger informational chain created by credit reporting services such as Dun & Bradstreet.[425] Weakening that link because we assume no one uses the link itself ignores the larger informational system of which it is a part, and which has come to replace more traditional community structures.

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419 *See* discussion *supra* Part II.B.

420 *See supra* text accompanying notes 185-86.

421 *See, e.g.*, Schwarcz, *Complexity*, *supra* note 16.

422 *See supra* Part III.B.2.

423 *But see supra* Part III.B.2.

424 *See* LoPucki, *Creditor's Bargain*, *supra* note 131.

425 *See* discussion in Part I.C.; Mann, *Verification*, *supra* note 138.

C. Behavioral Implications of Notice Filing

Discussions about information costs and communities run the risk of making inappropriate assumptions about how people process the information in question. In general, such discussions have been dominated by the economic analyses previously set forth.[426] While these analyses have produced both heat and light, they also have significant limitations. Perhaps the most important shortfall stems from their assumptions about human behavior. Economic analysis in general has been dominated by rational choice theory, the view that human beings are logical maximizers of self-interest.[427] Rational choice theory describes "how people would behave if they followed the dictates of a series of logical axioms, [and] posits that people make outcome-maximizing decisions."[428]

Perhaps the most important incursion into the rational choice fortress has come from the field of behavioral economics, sometimes called cognitive theory. Emanating from the work of Daniel Kahneman and Amos Tversky,[429] behavioral economists, and the many legal academics who trail in their wake,[430] have argued that human beings often make

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[426] *See supra* Part III.A.

[427] *See, e.g.*, Thomas S. Ulen, *Firmly Grounded: Economics in the Future of the Law*, 1997 Pt.1 WIS. L. REV. 433, 436 ("The single most important contribution that law and economics has made to the law is the use of a coherent theory of human decision-making ('rational choice theory') to examine how people are likely to respond to legal rules.").

[428] Chris Guthrie, *Prospect Theory, Risk Preference and the Law*, 97 NW. U. L. REV. 1115, 1116 (2003) (citing Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1060-66 (2000)). Herbert Simon describes the "economic man" who is perfectly rational as follows:

> This man is assumed to have knowledge of the relevant aspects of his environment which, if not absolutely complete, is at least impressively clear and voluminous. He is assumed also to have a well-organized and stable system of preferences, and a skill in computation that enables him to calculate, for the alternative courses of action that are available to him, which of these will permit him to reach the highest attainable point on his preference scale.

Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 99 (Issue 1, Feb. 1955).

[429] CHOICES, VALUES AND FRAMES, IX-X (Daniel Kahneman & Amos Tversky eds., Cambridge U. Press 2000); Daniel Kahneman & Amos Tversky, *Choices, Values and Frames*, 39 AM. PSYCH. 341 , 342-44 (1984); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Daniel Kahneman & Amos Tversky, *The Psychology of Preferences*, 246 SCI. AM. 160 (1982); Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297, 298 (1982); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453 (1981); Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039 (Issue 4, Nov. 1991); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S257-60 (1986).

[430] *See generally* BEHAVIORAL LAW AND ECONOMICS (Cass Sunstein ed., Cambridge U. Press

significant mistakes in judgment and analysis, or are influenced by emotions, moods, and feelings, which would be inconsistent with the rational actor model. While we may attempt to be rational, we often engage in what Mark Seidenfeld has aptly called "cognitive loafing"[431]—we find mental shortcuts ("heuristics") that help us make decisions. These heuristics, however, often lead to results that are demonstrably at odds with what rational self-maximizers would choose. In particular, these cognitive errors "plague many financial decisions,"[432] including those involving extensions of credit.

1. Cognitive Errors

Cognitive theory literature has sought to help us understand borrowing behavior. Professor Rachlinski recently catalogued three related cognitive biases that might lead to overinvestment in the form of taking on too much debt: (i) the "availability" heuristic, (ii) anchoring, and (iii) overconfidence.[433] The availability heuristic holds that we will more likely remember instances of overcoming hardship to pay debts than the failure to do so.[434] Anchoring means that a borrower roots her decision to borrow today in her past ability to satisfy obligations—not her anticipated ability to do so in the future.[435] Overconfidence means borrowers may tend to overstate their ability to foresee unfavorable economic circumstances which might lead to default.[436] Together, these biases create "vulnerability to excess indebtedness" that might influence how people decide to borrow money and perhaps how we develop rules

2000); Symposium, *Empirical Legal Realism: A New Social Scientific Assessment of Law and Human Behavior*, 97 NW. U. L. REV. 1075 (2003); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Gregory Mitchell, *Taking Behaviorism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 WM. & MARY L. REV. 1907 (2002); Jeffrey J. Rachlinski, *The 'New' Law and Psychology: A Reply to Critics, Skeptics and Cautious Supporters*, 85 CORNELL L. REV. 739 (2000); Cass Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 AM. L. & ECON. REV. 115 (1999).

[431] Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 523 (2002).

[432] Jeffrey J. Rachlinski, *The Uncertain Case for Paternalism*, 97 Nw. U. L. Rev. 1165, 1182 (2003) (citing Donald Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992)).

[433] *Id*. at 1183.

[434] *Id*.

[435] *Id*.

[436] *Id*.

governing the rights and remedies of those who engage in these transactions.[437]

Cognitive error has been studied in the context of securities law,[438] commercial law (e.g., sales),[439] and contract law.[440] However, to date, there has been no attempt to understand what these phenomena might imply for notice filing in commercial finance transactions. What might the behavioral effects of notice filing be?

First, the financing statement might counter the irrational optimism that comes from the collective force of the availability, anchoring, and overconfidence biases. As the warning that alerts a creditor to further investigate various competing claims to a debtor's property, the financing statement might slow the otherwise exuberant creditor from making a precipitous decision. It might inject a level of caution and deliberation, forcing the creditor to consider more carefully the full ramifications of the credit decision.

This, of course, assumes creditors actually pay attention to the information generated by financing statements. As suggested above, it is

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[437] *Id*.

[438] *See, e.g.*, William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311 (1984); Peter H. Huang, *Trust, Guilt and Securities Regulation*, 151 U. PA. L. REV. 1059 (2003); Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking Materiality of Information and Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99 (2005); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992); Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301, 315 (2000); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 634-41 (1996); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 859-62 (1992); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000).

[439] *See, e.g.*, Larry T. Garvin, *Adequate Assurance of Performance: Of Risk, Duress, and Cognition*, 69 U. COLO. L. REV. 71 (1998); Larry T. Garvin, *Disproportionality and the Law of Consequential Damages: Default Theory and Cognitive Reality*, 59 OHIO ST. L.J. 339 (1998); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 UNIV. CHI. L. REV. 1203 (2003); Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679, 1688 (1998).

[440] Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 213-14 (1995); Subha Narasimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123, 1142-49 (1986) (showing contracting parties rely on the "representativeness" and "availability" heuristics, which lead them to overestimate the likelihood that the terms of the contract will be performed); Russell Korobkin, *The Efficiency of Managed Care "Patient Protection" Laws: Incomplete Contracts, Bounded Rationality, and Market Failure*, 85 CORNELL L. REV. 1 (1999) (arguing cognitive errors in consumers justify imposing mandatory terms in health insurance contracts).

likely that they do, although this reliance may only be indirect.[441] But, if creditors do care about credit ratings in general, and those ratings reflect public information about nonpossessory interests in a debtor's property, then the result would be the same: The financing statement will, directly or indirectly, likely lead to more scrutiny of the debtor than would be the case if none were on record.

An even more basic point may also involve the general integrity of financial information systems. If creditors believe these systems give them information about the debtor that materially aids a decision to extend credit, the systems will develop a self-reinforcing authority. Creditors will be able to use the presence—or absence—of a filed financing statement as a kind of heuristic for assessing the debtor's credit worthiness.

If, by contrast, the system is viewed as unreliable, creditors may be expected to react with excessive caution. If creditors, purchasers, or others who care about the debtor's property have reason to believe that undisclosed interests in that property may be asserted against them, they will likely discount the value of that property and the value of the debtor as a potential trading partner. Whether a rational response to a lemons problem,[442] or a biased response that impedes self-interest, the lack of confidence in the system should, over time, affect the informational value of the system. If no one believes it is accurate, no one will rely on it.

2. The Reflexive Function of Notice Filing

Another behavioral implication of the notice filing system would look not at the effect that giving notice has on the presumed audience for the information—creditors and other investors—but instead on how notice filing obligations channel and possibly improve the behavior of those obligated to file. This has been an especially important and controversial topic in the securities law context, where disclosure per se—while voluminous—has not necessarily produced more intelligent decision making.[443] There is, nevertheless, a view that forcing corporate

[441] *See supra* notes 133-41 and accompanying text.

[442] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 500 (Issue 3, Aug. 1970) ("[T]he difficulty of distinguishing good quality from bad is inherent in the business world . . . .").

[443] Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 419 (2003) ("[T]he provocative implication of information overload is that the federal mandatory disclosure system might be more effective if it were scaled back—that is to say, if less were disclosed, not more."); Schwarcz, *Complexity*, *supra*

actors to divulge information about the firm and themselves will affect their behavior with respect to the firm and third parties.[444] This claim has, for example, been made where there are social or environmental consequences to corporate action that might be affected or altered by disclosure.[445] This "reflexive"[446] function of disclosure focuses on the ways in which behavior may be shaped by forced disclosure. Reflexive theories of disclosure capitalize on the idea that if we are forced to tell the world what we are doing, we may reflect more carefully on our actions than would otherwise be the case.[447]

How might this play out when applied to the UCC-1 financing statement? A debtor and a secured party, or securitization financer, who have no obligation to inform the world that one of them (the debtor) is conveying some property to the other will likely treat that property differently than if disclosure, no matter how discursive, were required. The property may, actually or metaphorically, be held out as an inducement to third parties of one sort or another, akin to the misplaced reliance considered so distressing by the court in *Clow*.[448] The debtor and the secured creditor may tolerate dissipation of the property or carelessness with its maintenance. If, however, the relationship has been disclosed, behavior might change.

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note 16.

444 *See* David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41 (1999); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

445 *See generally* Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227 (1995) (discussing environmental disclosure from a "reflexive law" viewpoint); Perry E. Wallace, *Disclosure of Environmental Liabilities Under the Securities Laws: The Potential of Securities-Market-Based Incentives for Pollution Control*, 50 WASH. & LEE L. REV. 1093 (1993) (analyzing environmental disclosure from a market-based efficiency perspective); Michael Barsa, Note, *California's Proposition 65 and the Limits of Information Economics*, 49 STAN. L. REV. 1223, 1239 (1997) (noting mandatory environmental hazard disclosure "also supplies powerful incentives for manufacturers to become informed about and possibly to reduce the carcinogens and teratogens in their products").

446 Reflexive law "attempts to influence decision-making and communication processes with required procedures." Hess, *supra* note 444, at 51 (citing J. Bregman & Arthur Jacobson, *Environmental Performance Review: Self-Regulation in Environmental Law*, *in* ENVIRONMENTAL LAW AND ECOLOGICAL RESPONSIBILITY 211 (Gunther Teubner et al. eds., J. Wiley & Sons 1994)).

447 Reflexive theories about securities law are nascent and are the subject of some controversy. *See* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L. Q. 487 (2003); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1407-10 (1999) (disclosure regimes may create false image of "corporate social responsibility"); *see also* RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING 867-83 (Lexis Law 1994).

448 *See supra* notes 30-31 and accompanying text.

The reflexive function of disclosure, Professor Malloy recently observed, is likely more powerful when disclosure rules are "fuzzy" rather than "binary."[449] A binary disclosure system is one in which compliance is "a black or white state of affairs."[450] Either disclosure has been given according to the prescribed rules or it has not. Fuzzy disclosure, by contrast, establishes "a gray relationship between an indeterminate standard and an uncertain factual situation."[451] Malloy has argued that in the presence of ambiguity, binary disclosure rules tend to undercut the reflexive effects that disclosure might otherwise produce, creating opportunities for strategic noncompliance.[452] "[B]inary disclosure provisions simply task [a] manager with answering the same question all over again."[453] Fuzzy disclosure rules, by contrast, "challenge[] the individual to think more closely about the position taken than would be the case absent the disclosure obligation."[454]

The UCC notice filing system as it has developed to date can certainly be seen as a binary system. As discussed above, the slightest technical errors in the giving of notice have often been used to avoid security interests entirely.[455] Where notice has been required, especially under prior law, the notice was either effective or it was not.[456] The survival of the security interest was a black and white matter that did not turn in any meaningful sense on the actual knowledge of those transacting with the debtor. Not surprisingly, this has led those who craft disclosure rules—the drafters of revised Article 9 and the securitization facilitation statutes, for example—to formulate rules that are as easy as possible with which to comply. The easiest disclosure rule to comply with, of course, is none at all, which is where our commercial finance law seems to be headed.

A fuzzier tolerance for the real distribution of information in any given situation might encourage more reflexive behavior on the part of those required to file notice (i.e., the debtor and the secured party). In

449 Timothy Malloy, *Disclosure Stories*, 32 FL. ST. UNIV. L. REV. (forthcoming 2005) (manuscript at 21, on file with author).

450 *Id*.

451 *Id*. at 21-22 (citing BART KOSKO, NEURAL NETWORKS AND FUZZY SYSTEMS: A DYNAMICAL SYSTEMS APPROACH TO MACHINE INTELLIGENCE 3, 33 (1992); MICHAEL SMITHSON, IGNORANCE AND UNCERTAINTY: EMERGING PARADIGMS 108-18 (1988)).

452 *Id*. at 39-43.

453 *Id*. at 42.

454 *Id*. at 48.

455 *See supra* notes 119-24 and accompanying text.

456 *See supra* Part I.B.2.

particular, Professor Malloy has argued, fuzzy disclosure rules may lead to greater individual accountability.[457] This may cause greater cognitive dissonance for those responsible for the filing, but may also lead them to consider more carefully the full effects of the course of action. This is, Malloy observes, especially important when disclosure might involve multiple audiences with potentially conflicting responses to the information in question.[458] Fuzzy disclosure rules, at least potentially, would require individuals to "engage in [a] more sophisticated evaluation of the alternative positions than under a binary disclosure scenario."[459]

Fuzzier disclosure rules might therefore reduce the likelihood of arbitrary avoidance, while still channeling and perhaps improving the behavior of those primarily responsible for generating and filing notice. If secured parties, in particular, were more concerned about who actually knew of their interest in the debtor's property, and less concerned with satisfying the binary rules of notice filing that have developed to date, they might be less inclined to engage in strategic but meaningless compliance. If, for example, a secured party could pursue data or intellectual property in the hands of remote parties only when the remote party actually knew or had reason to know of the proceeds security interest, the secured party could take steps to assure that that remote party had knowledge. If a security interest in a bank account would be enforceable only if other creditors of the debtor had some actual or constructive knowledge of the bank's interest in it, the secured party and debtor would likely take meaningful action to assure that it is known. Fuzzier rules would permit the easy transfer of property interests envisioned by revised Article 9 and the securitization facilitation statutes

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[457] Malloy, *supra* note 449, at 47-49.

[458] *Id*. at 50-51. Malloy's examples involve the conflicting disclosure pressures of federal environmental and tax laws.

[459] *Id*. at 50. There are, Malloy notes, important limits to this analysis. Among other things, "accountability in the complex context of the business firm and regulatory environment is still quite young." *Id*. at 56.

I also note that sophistication itself is an important, but not necessarily well-understood, feature of this analysis. It is somewhat artificial to cast the world in terms of "debtors" and "creditors" for purposes of this discussion, because many of the decisions about notice-filing will in fact be made by lawyers, not by the clients themselves. As Judge Posner observed, in critiquing psychological studies postulating the existence of an endowment effect, we often act not directly, but through more sophisticated intermediaries. *See* Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1566 (1998) ("When we do have something to sell, we usually sell through middlemen, such as real estate brokers, rather than directly to the ultimate consumer."). Although the behavioral implications of notice-filing should still matter for the clients, they will be cognitively intermediated by lawyers and perhaps other sophisticated parties.

with a reduced possibility of secrecy. Fuzzy rules may permit liens while inhibiting secrets.

There are undoubtedly other behavioral implications of notice filing, which may warrant further explanation. The important point here is that the system may have behavioral consequences that have not been fully internalized by those proposing changes in policy.

CONCLUSION

This Article has investigated the causes and effects of the reduction or elimination of notice filing from common commercial finance transactions, including those involving data, intellectual property, and bank and brokerage accounts. The principal cause appears to be excessive or misplaced concerns with economic efficiency. The principal effect will be increased incidence of secret liens.

Increasing tolerance of secret liens will have at least three collateral effects. First, by replacing notice filing with diligence and contract, we will increase information costs imposed on those who might affirmatively seek information about the existence of nonpossessory property interests. Second, by relaxing or eliminating notice filing, we ignore the role that these systems play in the development of merchant communities. Third, there may be important behavioral consequences for both those required to provide the notice and the audience for the information thus provided.

The massive coordination problems presented by nonpossessory property interests cannot be solved merely by the UCC-1. Indeed, information problems of the sort discussed here will likely always be with us. As Oliver Williamson has observed, "[b]ut for the limited ability of human agents to receive, store, retrieve, and process data, interesting economic problems vanish."[460] Yet, this simple piece of paper plays important roles—economic and otherwise—in generating information that, directly or indirectly, affects the commercial finance system at many points. Those who would reduce or eliminate notice filing have failed fully to consider the larger informational consequences of such decisions. In a world full of nonpossessory liens and other property interests, we should be wary of tolerating too many secrets.

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[460] Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 vol. 5 J.L. & ECON. 233, 234 n.5 (Oct. 1979).

ANNEX A

UCC FINANCING STATEMENT
FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]	
B. SEND ACKNOWLEDGMENT TO: (Name and Address) Granada Bank and Trust Co., N.A. 25 South Harbor Street Boston, MA 02110	THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

OR	1a. ORGANIZATION'S NAME Maimonedes Medical Finance Services LLC			
	1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

1c. MAILING ADDRESS 60 Boston Street	CITY Baltimore	STATE MD	POSTAL CODE 02101	COUNTRY USA

1d. TAX ID #:SSN OR EIN	ADD'L INFO RE ORGANIZATION DEBTOR	1e. TYPE OF ORGANIZATION LLC	1f. JURISDICTION OF ORGANIZATION Delaware	1g. ORGANIZATIONAL ID #, if any NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGALNAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

OR	2a. ORGANIZATION'S NAME			
	2b. INDIVIDUAL'S LAST NAME Principal	FIRST NAME Peter	MIDDLE NAME	SUFFIX

2c. MAILING ADDRESS 622 West 40th Street	CITY Baltimore	STATE MD	POSTAL CODE 02120	COUNTRY USA

2d. TAX ID #: SSN OR EIN	ADD'L INFO RE ORGANIZATION DEBTOR	2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATIONAL ID #, if any

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE OF ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

OR	3a. ORGANIZATION'S NAME Granada Bank and Trust Co, .N.A.			
	3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

3c. MAILING ADDRESS 25 South Harbor Street	CITY Boston	STATE MA	POSTAL CODE 02110	COUNTRY USA

4. This FINANCING STATEMENT covers the following collateral:
Equipment, inventory, chattel paper, accounts, general intangibles

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum if applicable)	7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA